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Blueprint for Professional Service Corporations

William J. Burke and
Basil J. Zaloom

BLUEPRINT FOR PROFESSIONAL SERVICE CORPORATIONS

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Blueprint for Professional Service Corporations

Introduction

The professional service corporation is a new business concept developed during the 1960's. Rarely has any innovation received such wide acceptance. Doctors and lawyers have been particularly active in taking advantage of this new concept. The concept deserves consideration by all professions—dentists, architects, etc., as well as doctors and lawyers—so long as the state statutes permit. The rapid acceptance of the professional service corporation is due largely to the tax advantages available to the corporate practice. The chief tax advantage will continue to be corporate pension and profit-sharing plans which are unavailable to the unincorporated practitioner.

The professional service corporation will appeal most to successful professional men. These men are also the busiest. Yet, for the incorporation to be successful, these men must be prepared to devote many hours in planning conferences. Wishfully, professional men may

search for a "specialist" to develop a "turn-key" corporation with all of the decisions prepackaged. This cannot be—for two reasons:

1. The planning involves some very personal interrelationships which must be developed, and there are personal needs and financial involvement which each participant must express and expose to the reactions and interactions of the group as a whole. Only in this way can the *needs* of the group be determined, and until needs are determined, specialists cannot produce the best plan. In fact, until this knowledge is available, the real specialist cannot be certain that a professional service corporation will best serve the needs of the group.
2. Then, only by personal involvement can professional men truly understand this creature known as the professional service corporation. To be successful, professional men must give the corporation full attention. Only by knowledge gained through the construction of the corporation can the professional men involved feel comfortable in its operation.

Professional men should realize that the structure of the professional corporation, the relationship of the professional man to the corporation, and a profit-sharing or pension plan designed for a professional corporation present problems and goals that are unique.

The professional service corporation is no panacea. Properly structured, it can offer many business advantages, but if it is formed by professional men who lack awareness of possible pitfalls, the corporation can become a serious business handicap.

The professional service corporation, when it is well designed, carries the promise of a wide variety of tax advantages, but if it is poorly conceived and operated, it contains numerous dangers for the unwary.

Professional service corporations are still subject to

attack by the Internal Revenue Service. Some tax aspects are still confused and the outcome is uncertain. Conditions may vary from state to state because of local laws. Consequently, it is not at all surprising that advisers differ sharply concerning many aspects of corporate and benefit plan design. No one will know with full assurance for some time to come which recommendations will prove best. This book claims no infallibility. Decisions by the courts, Congress, and the Commissioner of the Internal Revenue Service will play a part in the outcome. The Treasury Department's promised revised regulations may not be published for several years. Recommendations herein are based on one guiding principle: follow the course which will minimize the risks. The formation of a professional corporation is risk enough. Do nothing that will jeopardize its success as a business or its tax-savings advantage. Some professional men, encouraged by recent taxpayer success in the courts,[1] may feel that the tax threat to a professional service corporation is over. This book stresses that the professional corporation must guard against possible new lines of attack open to the Treasury now that its test of the 1965 Regulations has failed.

Most states have passed professional corporation laws. Most of the comments, recommendations, and procedures contained in this book will be applicable to professional service corporations in any state. However, certain sections must be interpreted in light of the con-

[1] The first seven cases reported were: Empey v. U.S., 272 F. Supp. 851 67–2 USTC 9638 (D.C. Colo. 1967) aff'd CA–10; 406 F. 2d 157, 69–1 USTC 9158, Cert. not authorized; O'Neill v. U.S., 281 F. Supp. 359, 68–1 USTC 9251 (N. Dist. Ohio 1968) aff'd CA–6, 410 F. 2d 888; Kurzner v. U.S., 286 F. Supp. 839 68–2 USTC 9514 (S. Dist. Fla.) aff'd CA–5, 413 F. 2d 97; Holder v. U.S., 289 F. Supp. 160, 68–2 USTC 9504 (N. Dist. Ga.) aff'd CA–5, 412 F. 2d 1189; Wallace v. U.S., 294 F. Supp. 1225 68–2 USTC 9669 (E. Dist. Ark.); Cochran v. U.S., 299 F. Supp. 1113 69–1 USTC 9250 (Dist. Ariz.); First National Bank and Trust Co. of Tulsa v. U.S., 69–1 USTC 9296 (N. Dist. Okla.), 23 AFTR 2d 69–903.

tents of the professional corporation act of the particular state. (Florida statutes are used for illustrative purposes because of the practical limitations involved in a summary of each state's law and because Florida's law has been widely recommended as a pattern for other states.) Comments in this book are not intended to be legal opinion. Their applicability will be affected by individual state laws. Legal counsel will always be necessary and should be employed at the inception of any feasibility study.

The importance of corporate planning and attention to details cannot be emphasized enough. Mesmerized by the tax-savings potential of corporate pension and profit-sharing plans and overconfident because of victories in the courts, professional men too often have concluded that attention to corporate details is unimportant. Far too often professional men have been led into a professional corporation without knowing the serious business and tax pitfalls that await them. This study is intended to help the reader realize the maximum potential to be gained from the professional service corporation.

PART ONE

The Professional Service Corporation—Its Past and Its Future

CHAPTER ONE

History and Current Status of Professional Corporations

"O oysters, come and walk with us!"
The Walrus did beseech.
"A pleasant walk, a pleasant talk,
Along the briny beach:
We cannot do with more than four,
To give a hand to each."

The eldest Oyster looked at him,
But never a word he said:
The eldest Oyster winked his eye,
And shook his heavy head—
Meaning to say he did not choose
To leave the oyster-bed.

But four young Oysters hurried up,
All eager for the treat:
Their coats were brushed, their faces washed,
Their shoes were clean and neat—
And this was odd, because, you know,
They hadn't any feet.

Four other Oysters followed them,
And yet another four;
And thick and fast they came at last,
And more, and more, and more—
All hopping through the frothy waves,
And scrambling to the shore.

Today's rapid proliferation of professional service corporations reminds us of this excerpt from that whimsical poem "The Walrus and the Carpenter," written by Lewis Carroll over a century ago. While it looks today as though our story will have a happier ending, it might be prudent for us to remember that the oysters were confident too—for a while. The case history of professional corporations is well known to most professional men. Over thirty years ago, in two landmark cases,[1] the Treasury argued and the Courts ruled that these two unincorporated business organizations should be taxed as corporations because they had sufficient similarities to a corporation. In those days, the Treasury was taking an exactly opposite position from its position today. (We may be sure that the Internal Revenue Service now considers those former victories Pyrrhic.) After successfully arguing that an unincorporated business organization could be taxed as a corporation, the Treasury suddenly realized what it had created when in 1948 it turned out to be to the tax advantage of a group of Montana doctors practicing as a clinic to be treated as a corporation for federal tax purposes.[2] At that time the Internal Revenue Service reversed its previous position and argued that the organization was a partnership. The Court of Appeals, however, held that the clinic had more of the characteristics of a corporation than a partnership and should be taxed as a corporation. The decision made Dr. Kintner, one of the doctors involved in the case, famous. Thereafter, the Galt[3] and the Foreman[4] cases reinforced the Kintner decision, the judges holding that these unincorporated associations should be treated as corporations for tax purposes.

[1] Morrissey v. Comm. (1935), 296 U.S. 344; Pelton v. Comm. CA–7 (1936), 82 F. 2d 473.
[2] U.S. v. Kintner, CA–9 (1954), 216 F. 2d 418 (54–2 USTC).
[3] Galt v. U.S. (N.D. Tex.) (1959), 175 F. Supp. 360 (59–2 USTC).
[4] Foreman v. U.S. (S.D. Fla.) (1964), 232 F. Supp. 134.

The Treasury announced that it would not follow the Kintner decision, and in 1960 the Treasury adopted regulations[5] designed to offset the effect of Kintner. By placing emphasis on local laws—probably because in most states professionals could not incorporate—the 1960 regulations attempted to make it as difficult as possible for unincorporated organizations to be taxable as corporations. Subsequently, professional men retaliated by securing state legislation which would permit the incorporation of professional practices.

Professional men waited expectantly for approximately four years, not knowing what the Treasury's policy would be toward the professional corporation. Many advised delay, expecting to know their policy momentarily. As time dragged on, it became apparent that the Treasury was playing poker, bluffing with what must be a poor hand. The result was a period of uncertainty, most professional men choosing to continue waiting on the sidelines for a clearer indication of what the future status of the professional corporation would be. There was no encouragement and little enlightenment when the Treasury issued its 1965 Regulations,[6] which, in effect, denied the corporate tax status to the professional service corporation. Further indication that the Internal Revenue Service preferred to gain by confusion what it feared it could not gain by direct attack was the Treasury's statement that it would not contest any deductions through 1964 resulting from the use of professional corporations. The showdown was thus prolonged.

Not many professional men were willing to gamble in the early 1960's. In retrospect, it seems those first adventurers into this strange land of professional cor-

[5] The so called "Kintner Regulations" under the 1954 Code, Treas. Regs. 301. 7701–2(a)(1), (2) and (3) replacing Regs. under Section 3797 of the 1939 Code.

[6] Treas. Regs. 301.7701 (1965).

porations were a hardy lot. The Treasury's obvious reluctance to test its position encouraged more professional corporations to be formed in the mid-1960's. Still, it was not until the District Court of Colorado, in 1967, wrote the Empey decision that the rapid increase in the formation of professional corporations began. Then, as additional favorable decisions were written, we find today—

. . . thick and fast they came at last
And more, and more, and more—

CHAPTER TWO

The Future of Professional Corporations

The Walrus and the Carpenter
Were walking close at hand:
They wept like anything to see
Such quantities of sand:
"If this were only cleared away,"
They said, "it would be grand!"

"If seven maids with seven mops
Swept it for half a year,
Do you suppose," the Walrus said,
"That they could get it clear?"
"I doubt it," said the Carpenter,
And shed a bitter tear.

It has taken more than seven District Courts with more than seven favorable decisions for the taxpayer to do it, but the issue of the 1965 Regulations has finally been swept clear. In August 1969, the Treasury announced that it was "conceding that organizations of doctors, lawyers, and other professional people organized under state professional association acts will, generally, be

treated as corporations for tax purposes." [1] In this same release, the Treasury stated, "Obviously, however, the Government must reserve the right to conclude differently in any case that reflects special circumstances not present in O'Neill or Kurzner." The O'Neill and Kurzner cases, along with Empey, were the professional corporation cases which the Treasury lost in the Court of Appeals. These three losses prompted the Treasury to concede the issue. It is not clear why the Treasury singled out the O'Neill and Kurzner cases for special reference, except that they were professional corporations of doctors while the Empey case involved attorneys.

Even though professional corporations survived the attack based on the Treasury's 1965 Regulations, the professional corporation may continue to live under the threat of litigation that is based on new arguments by the Internal Revenue Service. It would be optimistic to presume that the Treasury will not advance alternative arguments now that the present test of its 1965 Regulations has failed in the courts.

The Treasury may turn to Congress for the support it could not find in the courts. The Tax Reform Act of 1969 contains several changes that will affect professional corporations. Professionals should expect that the Treasury will continue to seek legislation in future years to offset recent tax advantages won in the courts by the professional man after years of effort.

The new Tax Reform Act of 1969 may force many professional corporations to abandon the Subchapter S election; yet, the corporation that does not elect Subchapter S tax treatment may well face the challenge that compensation is excessive or it may be attacked as a personal service corporation. The Subchapter S election is a provision contained in the 1954 Internal Revenue

[1] TIR–1019.

Code which permits a corporation to elect to be taxed generally as a partnership. To qualify to elect Subchapter S tax treatment, the corporation must meet certain requirements as to type and number of shareholders, etc., set forth in the code.

Will the Internal Revenue Service take the position that, if it is a corporation, then the professional service corporation is a sham or was "acquired" to save taxes and Section 269 applies? Section 269 permits the Internal Revenue Service to deny the corporate tax status to a corporation which was acquired to save taxes. The business advantages of the professional service corporation are discussed in Chapter Three. These advantages will present a strong rebuttal.

In at least one District Court case to date, the Arkansas Court (in the Wallace decision), the court did not seem disturbed that tax savings could have been a motivating factor in the formation of the corporation. The court in its decision stated, "It is clear that Arkansas adopted the statutes which have been mentioned for the express purpose of permitting professional people, such as doctors, lawyers, and dentists, to practice within the framework of corporations so as to gain the tax benefits which have been outlined." [2]

There have been several excellent published articles which attempted to predict the Commissioner's course of action should his 1965 Regulations ultimately fail. In the December 1968 issue of *Trusts and Estates*, an article by Howard J. Feldman entitled "A Look Beyond the 1965 Professional Service Regulations—With Some Alternate Solutions" presents a well thought out discussion on the subject. Mr. Feldman is particularly qualified to discuss this issue for he served as an appellate attorney in the Tax Division of the Department of Justice from 1964 to 1968. In that capacity, he was one

[2] Wallace v. U.S., 294 F. Supp. 1225.

of the attorneys who prepared the government's appeal in the Empey case.

Of particular interest is Mr. Feldman's discussion regarding the possibility that the government would abandon its attack based on the "Corporate Resemblance Test" and attempt, instead, to tax the shareholders of the professional associations and corporations as partners by using other tax doctrines, such as the "assignment of income" doctrine or a "sham transaction" theory. In his consideration of this question, Mr. Feldman stated:

The Government may be caught in an inconsistency if it attempts to apply such a test since its regulations appear to accept the professional organization as a corporation if it possesses a preponderance of the corporate characteristics without regard to the reason for its incorporation. From the practical standpoint, momentum is with the application of the corporate resemblance test as the Government's tool for classification and it is doubtful whether, with this past history in mind, the courts would even consider areas which depart from the corporate resemblance test.

In the *Journal of Taxation* issue of February 1969, Richard D. Hobbet's article "The Corporate Entity: When Will It Be Recognized for Federal Tax Purposes?" presented a different approach to the problem. In that article, the author stated that if the form of the professional corporation is upheld by the courts in the testing of the 1965 Regulations, the Treasury may next test the professional corporation on a "Form vs. Substance" battleground. He also feels the one-man professional corporation and the professional corporation that has operated in a careless manner will be vulnerable in this next arena. The author cites the series of cases which have been developed carefully by the government in the past few years to support this approach. Entertainers

and athletes have been particularly susceptible to this avenue of attack. In these cases, culminating now in the Rubin case[3] and in the Victor Borge case,[4] the court determined that the income was earned by the individual and not by the corporation. The trend here clearly indicates that the one-man professional corporation is subject to very close scrutiny.

Professor Hobbet warns of the pitfall of assuming that the professional corporation battle has now been won by the taxpayer and that he no longer need concern himself with the details of conducting his affairs within the corporate structure.

The curtains were parted only slightly by a recent article by Mr. K. Martin Worthy, newly appointed chief counsel for the Internal Revenue Service. Writing in the February 1970 issue of the *Journal of Taxation,* Mr. Worthy candidly discussed the Treasury's possible strengths and weaknesses in various professional corporation problem areas without disclosing how strong a position the Treasury will take on any one of these issues. His article is recommended reading.

If professional corporations, particularly the one- and two-man groups, relax their guard, they can well become the next target. Such an attack, supported by the latest court cases, may prove to be far more dangerous than the Treasury's frontal assault on all professional corporations.

Now that the Commissioner has finally hit upon a successful means of attacking certain corporations formed to render personal services, more emphasis on this approach can be expected. The attack on personal service corporations began with the Tax Court decisions upholding the Treasury's reallocation of a portion of in-

[3] Richard Rubin, 51 TC 251.
[4] Victor Borge v. U.S., CA–2 (1969) 405 F. 2d 673 (T.C. Memo 1967–173).

come from Victor Borge's corporation to him personally. In that decision, the court offered the suggestion that the Commissioner could have claimed that all of the corporation's income was earned by Mr. Borge and, therefore, the Commissioner could properly tax it to him under Section 482. Section 482 gives the Internal Revenue Service the right to reallocate income among taxpayers if the reallocation will more correctly reflect true income.

The same suggestion was made first in the case of movie director George Cukor. The Treasury then took the advice of the Tax Court and won a case with this argument.[5] Now the latest decision involves the three McGuire Sisters,[6] who formed a corporation through which they sold their singing engagements. The Treasury reallocated the income to them personally under Section 482, and the jury found that such an allocation of income was not capricious or arbitrary. With the ability to reallocate the income of three performers under Section 482, the Treasury will give much consideration to the same attack against a professional service corporation. While there may be many differences between cases such as Borge and McGuire and a professional practice, there are also similarities.

When the first four young Oysters hurried up to meet them, the Walrus and the Carpenter found that "their coats were brushed, their faces washed, their shoes were clean and neat." The first professional corporations that went to the courts presented the same neat appearance. Unfortunately, not all professional corporations have operated in such a neat and proper manner. No one can predict what the courts will hold when a poorly operated professional corporation appears for a test. Evidence in recent cases involving entertainers in-

[5] Supra 3.
[6] Dorothy McGuire v. U.S. (S. Dist. N.Y.), 23 AFTR 2d 69–800.

dicates that such careless behavior will make it easier for the Commissioner to assert a Section 482 reallocation of income from the corporation to the professional man. Remember that the Treasury conceded only that professional organizations will *generally* be treated as corporations, while reserving the right to rule differently in any case that reflects special circumstances not present in O'Neill or Kurzner. In fact, the Treasury has just won its first case[7] against a group of doctors who operated more like individuals than a corporation. The Tax Court held that a professional corporation must act like a corporation in order to be recognized as one. To operate carelessly is to needlessly invite attack.

[7] Jerome v. Roubik, 53 T.C. No. 36.

CHAPTER THREE

Advantages of Practice in the Corporate Form

TAX BENEFITS

The only real asset that most professional men possess is their ability to go to work tomorrow. Many do have adequate insurance programs, but few accumulate investments during their professional lifetimes to provide for retirement. The professional corporation is an excellent vehicle for the professional man to establish a retirement program through a corporate pension or profit-sharing plan. The ability to put money aside by deductible contributions to such a plan and have the income of the plan compound tax free is the greatest tax attraction of a professional corporation for the professional man.

In addition to a pension or profit-sharing plan, the professional man should consider the tax savings which can be afforded by:

1. Medical benefit plans
2. Group health, accident, and major medical insurance
3. Disability insurance
4. Sick-pay plans
5. Group life insurance
6. Death benefits for widow and children
7. Estate tax benefits
8. Lower corporate tax rates on retained earnings

None of these benefits would be available to a sole proprietorship or a partnership.

BUSINESS ADVANTAGES

In at least two cases, the courts have recognized valid business purposes for the formation of the professional service corporation. In O'Neill,[1] the court stated, "The principal purpose in changing the form of the organization from partnership to corporate status was the non-tax business purpose of controlling a sizable and unwieldy organization." Then in Holder,[2] the court stated, "The principal purpose of forming the association was the business purpose of controlling a sizable and unwieldy organization and to obtain other benefits, such as limited liability, provided by the Georgia Professional Association Act."

It is not surprising that the Treasury contended that these arguments were mere window dressing. It is unfortunate that not only the Treasury but also many professional men do not recognize, as the courts did, the rapid changes going on in the professional world today and the true importance of these two points.

[1] O'Neill v. U.S., 281 F. Supp. 359, 68–1 USTC 9251 (N. Dist. Ohio 1968) aff'd CA–6, 410 F. 2d 888.
[2] Holder v. U.S., 289 F. Supp. 160, 68–2 USTC 9504 (N. Dist. Ga.) aff'd CA–5, 412 F. 2d 1189.

Great changes are under way which will reshape the structure of professional organizations in the next decade. Those who remember professional practices as they existed immediately after World War II will recall that conditions were much less complex and demanding than they are today. Professional men in those days were, by and large, individualistic by nature, preferring their individual independence to the give-and-take required by a group practice with partners. Many factors have contributed to the change since then. The knowledge explosion since the end of World War II has forced professions to specialize even within the areas of historic specialties. The public demands far more services than it did twenty years ago, and the public also expects a higher degree of competency. The demand for skilled professional men is growing at a faster pace than the supply. Income has increased and this, coupled with the increase in tax brackets, means that it is not nearly so necessary to guard jealously the revenue produced personally.

His own physical ability to hold up under increasing pressures and demands causes much concern to today's professional man. The relief from pressure, plus assurance that the firm will continue despite temporary or even prolonged illness, is a real attraction of group practice. Other factors, such as the ability to consult, the ability of members to assist one another, and the possibility of more study and leisure time, have made group practice far more prevalent.

Many professional men will testify that they originally built their group practice seeking these advantages even if it meant the sacrifice of income. The paradox is that the group practice has made more efficient use of the professional man's time and often has actually increased, not decreased, his income.

Furthermore, a group can build a "firm name" repu-

tation normally not attainable by the individual. Because it can offer specialties and better or surer coverage, the group is more likely to receive referral work. With an established "firm name" and reputation, the professional group can effectively add well-trained young professional employees whose production will be generated by the firm's reputation, not their own. There are other economies in group practices, such as more efficient use of clerical labor, office space and other overhead expense items. When the group practice is large enough to justify a business manager, the professional man is relieved of many hours of nonproductive chores.

The business structure of a growing organization is of utmost importance to its long-term success. Because professional men by their very nature not only are in great demand but are still individuals, no legal entity, not even a professional service corporation, will guarantee a *perfect* stability within the group. Professional men are brilliant and independent individuals who at times become dissatisfied, and in any organization there will still be personality conflicts. The professional service corporation can build group stability and provide the professional man with a more intelligent vehicle for doing business.

Here are some of the business advantages of operating in a corporate form:

A. Ability to Attract and Keep Key Personnel

A well-organized business is impressive to any new recruit. The ability to attract skilled young men to the organization is a key factor in the development of a professional practice. Fringe benefits will prove to be most attractive. The professional practice must com-

pete with industry, colleges, and the government—all of them offering attractive retirement or profit-sharing plans and other benefits.

The Treasury seems to believe that a pension or profit-sharing plan is merely a tax dodge for the present stockholders. It can be far more than that; it can be a means not only to attract outstanding young men to the organization, but also to hold them with financial ties through the difficult years when they may seek greener pastures. It is a fact that economic conditions and demand for professional talent today make it far easier for a young man to launch out "on his own" than was possible in years gone by. These same remarks apply to a lesser degree to the attraction and retention of good clerical employees.

While the self-employed (Keogh) plan is available to an unincorporated practice, it compares so unfavorably with corporate plans that it may serve only to emphasize the plight of the professions if the Treasury's attack on the professional service corporation is successful. The self-employed (Keogh) plan is explained in detail and compared with corporate benefit plans in Chapter Thirteen.

B. Flexible Adjustment of Compensation and Voting Control

Equally important in the attraction and retention of key young men, who will help build the organization, is the inherent flexibility to adjust compensation and voting powers. In a partnership, profits and voting are ordinarily determined by the "points" assigned to each partner. While the older partners may have reached a financial status in which they would be willing to give up income, they are often not willing to give up voting

control as well. In a professional corporation there is no need for the relationship of stock ownership and compensation to be the same. The board of directors may raise or lower compensation based on performance while maintaining a more stable voting structure. As professional men perfect this management tool, this may prove to be one of the most useful features of the professional corporation. If this prediction proves correct and the average professional organization grows larger and more complex in the decade to come, this flexibility, permitting the separate adjustment of income and voting strength, will permit a centralized management to meet and solve problems before they become crises.

C. Easy Transferability of Interests

As the organization adds new stockholders, and other stockholders retire, die, or become disabled, the ease with which stock can be issued, retired, or adjusted will contrast favorably with reorganizing a partnership which is often legally dissolved by these events.

D. Centralized Business Control

Business control can be centralized in a few individuals capable of properly managing the organization. Professional men have great income-producing potential. Nonproductive time should be controlled. The group will be more productive if fewer people are involved in the nonproductive aspects of business activities. It is also true that men with brilliant professional minds may exercise less than brilliant business judg-

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ment and that in the professional corporation these men cannot bind the others by imprudent personal action.

E. Limited Liability

Malpractice cases against professional men are increasing. The courts are more and more prone to rule against the professional man, and the judgments are getting larger. The result is that professional liability insurance is becoming more and more expensive and in many areas very difficult to obtain at all. As group practices grow larger, the possibility that professional men can be bankrupted by the negligence of one of their partners is a sobering thought.

Finally, it must be realized that while much has been said about liability originating from services performed in a professional capacity, the professional service corporation is also a business. If a victim of imprudent management, such a business might find the limited liability protection of a professional service corporation an invaluable feature.

The state professional service corporation statutes which limit professional liability to the action of the professional man himself and those he is directly supervising in a professional capacity have produced a benefit of such importance that groups should consider practicing in a professional corporation for this reason alone.

Both the Internal Revenue Service and the taxpayer should listen carefully to the opinion of the courts in the O'Neill and Holder cases, which rule that the business organizational structure and limited liability are valid business purposes for the formation of a professional service corporation.

APPLICABILITY TO THE ONE- OR TWO-MAN CORPORATIONS

Do these same corporate advantages apply to the sole practitioner or the two-man partnership? The next decade will see professional men becoming more in demand and with more productive potential. The complexities of business and technical knowledge will pyramid. Groups will practice in sizable organizations to achieve more income, with less pressure and demands on time. If these predictions come true, the partnership form is much too simple and inefficient to operate such a modern business enterprise. For this reason, the members of a one- or two-man practice who have the desire to expand it should develop the appropriate form of organization at the beginning, and not when the practice is full grown. In classical mythology, Minerva, the daughter of Jupiter, leaped forth from his brain, mature and in complete armor. This is not the normal way to rear children or business organizations.

One of the reasons some professional corporations will fail is that today's professional men have grown up in a different business atmosphere and are unable to recognize the advantages of the professional corporation practice or to adjust to them. It has been observed that a business enterprise develops a personality quite as surely as does an individual, and it is often just as hard to change. The one- or two-man organizations, at a disadvantage in the recruiting battle, would have a better chance to attract outstanding young professional men if they were able to show potential recruits the "blueprints" providing for their future, the company structure and ways they would fit into it, and the fringe benefits offered. Within this potential may lie the real financial attraction of the professional corporation.

CHAPTER FOUR

What Are the Risks or Costs Involved in the Use of Professional Service Corporations?

Because there is such a strong body of legislative history supporting professional corporations, more and more professional men will conduct their practice as a professional service corporation. Before incorporating, however, they must be well aware of all possible pitfalls as well as advantages.

A. Tax Status Not Certain

While the self-employed (Keogh) plan for the unincorporated practitioner is an approved program for tax purposes, the professional corporation is still subject to additional attack by the Internal Revenue Service.

Professional men must be prepared for the trauma of battle with the Internal Revenue Service. Those who are not possessed of a temperament to see the issue through should hesitate to use this vehicle. While

the examining revenue agent is at it, other deductions, such as entertainment, automobile and travel expenses, will be examined more carefully than they might otherwise be, and the professional man is increasing the risk of a tax examination.

B. Collapsible Corporations

If the professional corporation elects to report on the cash basis for tax purposes, as almost all do, the cash-basis accounts receivable may cause the corporation to be considered a collapsible corporation.

If the corporation is a collapsible corporation, any professional man who sells his stock and realizes a gain will be taxed at ordinary income rather than capital gain rates on the gain. The same is true on gains realized in liquidations. Furthermore, liquidations under Section 337 or 333 may not be available.

Section 337 permits the sale of a business and the liquidation of a corporation within one taxable year without the double tax impact of a capital gain to both the corporation on the sale and to the stockholders on the liquidation of the corporation. Section 333 has special advantages, under certain circumstances, which permit the deferral of all or a substantial portion of the gain on liquidation.

Code sections and regulations[1] stipulate that unrealized receivables or fees from services to the extent that they have not been included in income are "Section 341 assets." It might be argued that the professional corporation is not collapsible because Section 341(b)(1) requires the "Section 341 assets" be *purchased* to bring the corporation within the definition of the term "col-

[1] IRC (1954) Sections 341(b)(3)(c) and 341(b)(4) and Treas. Regs. 1–341–2(b)(4).

lapsible corporation." It is possible, however, that the rendering of services which gave rise to the receivables would be considered a purchase for this purpose, because the conversion of unrealized ordinary income of this type into capital gains (by sale of stock or liquidation) is exactly what Congress attempted to prevent by the enactment of Section 341.

The collapsible corporation problem is mitigated to some extent if, as is suggested later, accounts receivable and goodwill are not considered in the stock redemptions formula. (See Chapter Eight, Section B.)

C. Failure to Act as a Corporation Is a Risk; Adherence Can Be a Nuisance

In spite of the amount of detailed planning, consultation, and explanation that may precede the formation of a professional corporation, many a professional man is unable to grasp the full implications of a professional corporation, its effect on the professional practice, and the financial consequences to himself. That is, he is unable to grasp them until they become some specific reality at a later date. Some professionals may have a complete lack of understanding of what is involved in operating under centralized management, in being an employee, in attending meetings, keeping minutes, and setting compensation. Personal differences in ability to forgo after-tax dollars that may be funded into a plan may also create problems. Professional men are often very individualistic. It may prove difficult in practice to fit the historic format of operations of some partnerships into the requirements of a professional corporation. Still the concepts recommended in this study will do much to clarify issues and smooth out both the transition and subsequent operations.

Professional men must be able to regiment themselves to operate within the somewhat confining structure of a corporation. If there is any feeling that such regimentation will prove to be annoying beyond acceptance, then the group should consider seriously whether the advantages are worth the risk of future disenchantment with one another. For those who would venture into a professional corporation with the impression that they can ignore the need for regular meetings of stockholders and directors, that they can operate as individuals in dealings with third parties and their patients or clients, and, in all other respects, deal with one another as individuals or partners rather than as employees and stockholders in a corporation, then they are preparing the government's case in advance and should avoid the use of a professional corporation. The professional man must learn to structure his personal financial needs so that he can live within the compensation developed by the corporation. He should not look upon any money contributed to a pension or profit-sharing plan as short-term investment which is readily available to him to meet any personal financial crisis which could occur in the near future. He must realize the money is, for all intents and purposes, locked away until retirement.

D. Additional Expenses Will Be Incurred

Workmen's compensation insurance and unemployment compensation tax will be an expense factor to consider because the professional men will now be employees. There will be costs involved in incorporating and creating the contracts and benefit plans desired. (Increased social security taxes will be offset by income tax saved, because 50% of the cost, the corporation's

share, will be deductible.) There will be annual legal and accounting fees to review and update, and forms to be filed. Finally, there is the contingent legal cost to fight any future battles with the Internal Revenue Service. It appears that the present test of the 1965 Regulations has been concluded by the issuance of the Treasury's August 1969 announcement,[2] and this issue will not require litigation by any corporation formed now. Still, the possibility that some corporations may be required to litigate either this issue or some new avenue of attack by the Commissioner does present a contingent cost factor that should be considered. Currently, it would seem that the one- or two-man corporations face the greatest risk of future litigation, with fewer men to share the expense burden.

E. Tax Problem if the Present Partnership Is on a Fiscal Year

Special care must be taken in timing the transfer to a corporate operation if the partnership practice is on a fiscal year. The transfer could result in a serious "bunching" of income because the partnership's earnings for its fiscal year will be taxed to the professional men along with any corporate salaries, bonuses, or dividends received in the year of incorporation. The timing of the transfer to a corporation and the corporate tax planning decisions could become critical.

F. Possible Inadequacy of Some State Statutes

Many corporate attributes may be limited by an inadequate state statute. Such a weakness may be incura-

[2] TIR–1019.

ble other than by amendment of the state law. In such cases, legal counsel may advise delay in incorporating until the state professional service corporation statutes are amended. The Treasury has reserved the right to attack those corporations where there are "special circumstances not present in O'Neill or Kurzner."

G. Special Risk of the One- or Two-Man Corporation

At one time, most advisers felt that a number of professional men in the corporation would be necessary to insure the success of the professional corporation status. However, in the Kurzner case in Florida, the professional corporation was formed by the incorporation in 1961 of the sole proprietorship of Dr. Gregory. In 1962 it became a practice of two doctors when Dr. Kurzner was employed. He acquired an equal stock interest from 1964 through 1966. Although at first there was only one and later there were only two professional men practicing, the taxpayer was successful in both the District Court and the 5th Circuit Court. The Florida law states that one person may incorporate and become the only shareholder of a professional corporation.[3] In Kurzner, there were always three stockholders, including one or two doctors not directly connected with the practice who owned one share each.

In professional corporation cases decided to this date, the District Courts have held the Treasury's 1965 Regulations on Professional Corporations and Associations invalid as being unreasonable, discriminatory, and in conflict with the statute and the cases construing it. Since the decisions were based on the validity of the

[3] Chapter 621.05, Florida Statutes.

regulations, a one-man practice may prove to be as defensible in this respect as any other professional corporation if it complies in all respects with state law and conducts itself properly.

The one-man professional corporation may very well pass the current test of the 1965 Regulations and yet be the next subject of attack by the Internal Revenue Service. The Commissioner may argue that the corporation is a sham, or he may attempt to apply Section 482, which would reallocate all the income to the professional man. A small group may also be vulnerable to attack if it does not conduct business in a corporate manner. The one- and two-man professional corporations are especially advised to conduct business meticulously as a corporation.

Should the courts fail to find a "business purpose" for the one- or two-man corporation, the Internal Revenue Service may successfully apply Section 269. Application of Section 269 would hold that the corporation was "acquired" to save taxes and thus deny corporate tax benefits.

H. Sacrifice of Currently Spendable Income

To take advantage of any deductible pension or profit-sharing plan, professional men must be prepared above all to give up currently spendable income. Take as an illustration the professional man in the 50% bracket who can invest $8,000 per year toward retirement. If he makes the $8,000 contribution to a corporate plan, he will reduce his current after-tax spendable income by $4,000 (the $8,000 contribution less $4,000 tax saved). As vulnerable tax-wise as those last few dollars of taxable income are, the professional man who must have every dollar he can earn to meet per-

sonal commitments will find little comfort in the tax advantages of a corporate employee plan. A deductible employee plan is not a sieve that filters out federal taxes while permitting spendable dollars to trickle through to the individual.

CHAPTER FIVE

The Value of a Good State Law

The professional service corporation is a product of the state, not of the Internal Revenue Code, and cannot exist apart from state law. Surprisingly, various state legislatures have responded quickly since the early 60's so that at least forty-seven states now possess some form of professional association or professional corporation legislation,[1] and this list may be incomplete as legislatures are continually reviewing the question. The statutes have been independently written by each state and nothing has been done to date to make the laws uniform. The formation, structure, and operation of a professional corporation are governed by the provisions in its own state law. Furthermore, each state law identifies the professions which are permitted to incorporate. The state law normally will specify the minimum

[1] A. I. Schutzer, "Now Even Solo Doctors Are Incorporated," *Medical Economics*, September 1969, states that forty-six states now permit professional organizations. Of these, thirty-two have laws authorizing "soloists" to incorporate their practices.

number of professional men who can incorporate, and it will set limitations to ownership of stock and transfer rights or restrictions on stock. Each state law will set forth the extent of limited liability, if any.

Because state laws vary, it is altogether possible that the case for professional corporations may be stronger in some states than others. Therefore, at the very inception of any feasibility study, it is important for legal counsel to explain state law provisions in the light of court cases to date, as well as the position of the Internal Revenue Service stated in its 1965 Regulations.

Florida has one of the stronger laws protecting the professional man against the position taken by the Internal Revenue Service in its 1965 Regulations. Berrien C. Eaton, Jr., stated in a recent article:[2]

The Kurzner case, D.C. FLA., 7/3/68, which was decided by Florida District Court, involved a "Professional Association," i.e., a corporation, formed under the Florida Professional Service Corporation Act. This Act has been copied or adopted in several states including Michigan.

In a footnote to that same statement, the author pointed out that Florida improved its law in 1967 by an amendment which, among other things, (1) provided that stock ownership is not dependent on employment and (2) liberalized the restriction on alienation of shares to provide merely that no shareholder may sell or transfer his shares except to another individual who is eligible to be a shareholder.

Howard J. Feldman in an article[3] also referred to the Florida Act stating:

[2] Berrien C. Eaton, Jr., "The New Professional Corporation Cases: Taxpayers Win Four Straight," *Journal of Taxation,* October 1968.
[3] Howard J. Feldman, "A Look Beyond the 1965 Professional Service Regulations—with Some Alternate Solutions," *Trusts and Estates,* December 1968.

Effective September 1, 1967, Florida amended its Professional Service Corporation Act to provide that a stockholder does not have to be employed by the corporation and that the personal liability of stockholders can be no greater than that of a stockholder in an ordinary business corporation. It also deleted the requirement that a shareholder may sell or trade his shares only with the consent of the other shareholders. Such changes were undoubtedly meant to conform the Florida Act to the requirements of the Regulations with respect to transferability of shares and limited liability. Without question, the Government's arguments concerning these characteristics have been greatly weakened, if not eliminated. This is the prime example of another alternative left to taxpayers if the Regulations are valid: tailor the state statute to fit the federal definitional standards rather than vice versa, i.e., amending the federal statute and interpretive administrative pronouncements to fit state enabling acts. Since Florida and other states appear to be eliminating the most important remnant of the group practice of professionals, mutual liability, there would seem to be no objection to amendments to state acts giving professional service organizations all the characteristics of an ordinary corporation or, better yet, permitting the incorporation of professionals under the general incorporation law.

In a footnote to that last statement, Mr. Feldman also adds: "Possibly the only requirement necessary would be that the shareholders must be licensed in the profession carried on by the organization. This can be done through Court rule for attorneys or the various licensing statutes for doctors."

The reader should check his own state law to determine the extent, if any, of limited liability to be afforded by his state's Professional Service Corporation Act. If no provision for limited liability exists, there is a very serious deficiency in the act, both in its tax and business aspects. The professional men in that state should consider seeking an amendment to the state

statutes. Not only is any professional corporation formed in such a state vulnerable to attack based on the 1960 and 1965 Regulations, but also a very good business purpose for forming the corporation is missing. Without the feature of limited liability, there may exist the threat of attack by the Internal Revenue Service based on Section 269, charging that the corporation should be ignored for tax purposes because it was formed for tax purposes alone.

CHAPTER SIX

Ethical and Professional Society Restrictions

The individual who is studying the feasibility of practicing in a professional service corporation must consider possible ethical restrictions of his profession as well as the law of his state. The professional is never well-advised to flout the decision of his own professional society rules on ethics.

The individual state law may place restrictions on the permitted name of the corporation. For instance, the Florida law is explicit on the subject. Whether the state law covers the subject or is silent, any pronouncement by the particular state professional society should be consulted.

Most state professional societies have ruled on who may be an officer, director, or stockholder in a professional service corporation, and these rulings may be in conflict with the state statute. All of these rulings should be studied in the preliminary planning stages of the feasibility study.

The professional society pronouncements should be studied to determine if adoption of a profit-sharing plan would be deemed "sharing profits with the laity" and thus unethical.

The professional society's ethics committee ordinarily will have expressed its opinion as to the proper way the corporation and/or the professional men will be listed in the telephone book, in professional publications, etc.

CHAPTER SEVEN

Corporate Characteristics Under the 1965 Regulations

The Treasury generally conceded the professional service corporation issue in its TIR-1019 of August 1969. The Treasury also stated that it will modify existing regulations to conform to its new position of generally recognizing professional service corporations. These 1965 Regulations are still the yardstick used to evaluate those situations where a particular association is formed under circumstances which may not be comparable to O'Neill or Kurzner.

The discussion of the Treasury's 1965 Regulations is included here to give the reader an idea of the problems involved, as well as an idea of the importance of the wording of the law of his particular state. The discussion indicates the advantages possessed by professional service corporations (in states such as Florida) which are supported by a well-written law and helpful Attorney General rulings.

Reg. Section 301.7701–2(a)(1) states:

An organization will be treated as an association if the corporate characteristics are such that the organization more nearly resembles the corporation than a partnership or trust. See also Morrissey et al. *vs. Commissioner (1935) 296 U.S. 344.*

Having said this, however, the Commissioner proceeded to add Subsection (h) to his 1965 Reg. Section 301.7701–2(a) through (g). Subsections (a) through (g) contain the general requirements which all other organizations must meet in order to be classified as an association taxable as a corporation. The insertion of Subsection (h), which is applicable only to professional service corporations, reads more like a tax brief than a standard of measure. As the salient points of Subsection (h) are described in this chapter, the reader could well ask, "What professional service corporation could possibly qualify under the arguments and conclusions contained in this Subsection?" The answer, of course, is that the Subsection was written as a basis to deny corporate status to all professional service corporations.

The Morrissey case, it must be remembered, involved an unincorporated association and not a professional service corporation. In Morrissey, the court spelled out six characteristics by which an unincorporated association should be judged in deciding whether it had characteristics more like those of a corporation than a partnership. While the first two of its characteristics as listed here should apply only to unincorporated associations, all of the Morrissey characteristics were carried forward from 1935 as the basis for the Treasury's 1965 Regulations.

A. Associates

A one-man professional corporation would certainly seem to violate Regulations which require that there be associates. However, the Morrissey decision was based on a test of an unincorporated association. Many regular corporations have but one stockholder so that it is not at all unlike a corporation for a professional service corporation to have but one stockholder if the state Professional Service Corporation Act permits. It has already been pointed out that while it would appear that the single stockholder may well survive the test of a lack of associates, there are other more serious, possible threats.

B. Profit Motive

Benevolent and passive organizations are distinguished from those organized for a business profit motive.

There seems to be little reason for the Commissioner to include this test except that he is attempting to parallel the Morrissey decision to support his 1965 Regulations. The profit motive test would be valid if it were applied to certain trusts and other noncorporate associations to see if that trust or association had the attributes necessary to tax it as a corporation, but, applied to the professional service corporation, it is meaningless.

C. Centralization of Management

The Treasury's provision on centralization of management is spelled out in general terms in the Reg. Section

301.7701-2(c). The Treasury's specific argument that professional service corporations do not possess the necessary degree of centralization of management is contained in Reg. Section 301.7701-2(h)(3). While the Commissioner is attempting to argue that there can be no centralized management in view of the fact that professional decisions must necessarily be made by the individual professional man, the Commissioner himself has ruled in other cases that control over general policies and general standards sufficiently constitutes centralized management, and he has further held that doctors may be employees rather than independent contractors under certain circumstances.[1]

It should be noted that in the Foreman[2] case (a case involving an unincorporated association), the court found the required centralization of management even when all of the beneficial owners were active in the management of the practice.

There seems to be no particular reason why professional corporations should be judged any differently from small regular corporations, where a few individuals are stockholders, directors, officers, and employees. A larger group can display a semblance of centralized management more easily than a smaller group. Again remember that in the Kurzner[3] case, the corporation was originally a one-man practice, and was never more than a two-man practice. Furthermore, the facts indicated that they exercised little supervision over one another.

Although the government is stressing the individuality of decisions in the area of professional matters, there are many nonprofessional business decisions required

[1] 1961–2 Cum. Bull. 153, 155, Rev. Rul. 61–178 and Rev. Rul. 61–196.
[2] Foreman v. U.S. (S.D. Fla.) (1964), 232 F. Supp. 134.
[3] Kurzner v. U.S., 286 F. Supp. 839 68–2 USTC 9514 (S. Dist. Fla.) aff'd CA–5, 413 F. 2d 97.

which the Commissioner chooses to overlook. In the Kurzner case, according to the court's finding:

The Board of Directors has held regular weekly meetings, regular annual meetings, and certain special meetings since incorporation. Written minutes of the annual and special meetings have been transcribed. The Board of Directors has made the decisions relative to bonuses, call schedules, vacations, and hiring and firing of non-professional employees. It has annually determined the total amount of bonuses to be distributed to the doctors and it established a pension plan for employees.

D. Limited Liability

The Treasury's general coverage of the limited liability subject is contained in Reg. Section 301.7701-2(d). Limited liability as it relates to professional service corporations is contained in Reg. Section 301.7701-2(h)(4).

While a partnership can have the attributes of associates, profit motive, and centralized management, the limited liability attribute is one exclusively applicable to corporations. The Florida Professional Service Corporation Act[4] renders only that employee who actually commits, directs, or supervises a negligent or wrongful act personally liable to the person to whom the professional services were rendered, while limiting the liability of the other corporate shareholders to the full value of the corporate assets. While this may not meet the Treasury's interpretation of limited liability of the normal corporation, it has none of the features or attributes of a partnership. Certainly limited liability is a good business reason for incorporating. The Treasury's position was that an individual can escape all

[4] Chapter 621.07, Florida Statutes.

personal liabilities if he is an employee of a regular corporation, but this is not so. The employee of a regular corporation who commits a wrongful act that injures others is personally liable. The liability is from his act, and not by virtue of the fact that he is or is not a stockholder.

E. Free Transferability of Interests

The general provisions regarding transferability of interests is found in Reg. Section 301.7701-2(e). The Treasury's position on the free transferability of interests of the professional service corporation is contained in the 1965 Reg. Section 301.7701-2(h)(5)(i)(ii).

The Florida Legislature in 1967 amended its Professional Service Corporation Act to read:

No shareholder of a corporation organized under this act may sell or transfer his shares of such corporation except to another individual who is eligible to be a shareholder of such corporation.[5]

The Florida Act does not require stockholders to be actual employees of the corporation and any stockholder who is also an employee may terminate his employment and still continue to own his stock. The amendment effectively removed the Treasury's primary argument on this issue. Even in its original form, the Florida Act rendered the stock more transferable than would be a partnership interest because such a transfer would not have worked a technical dissolution nor created an automatic right to an accounting. A great many closely held general corporations contain stock redemption agreements by which an orderly transfer of stock owner-

[5] Chapter 621.11, Florida Statutes.

ship may be effected in the event it becomes necessary. Also there are many situations, both contractual and statutory, in today's corporate climate which make greater restrictions on transferability than does the status of the professional corporation. The courts did not find that they are acting unlike a corporation when professional service corporations contain some restrictions on transferability. There is nothing in the Florida Act which restricts free transferability of interest or that makes continued employment a prerequisite for ownership of stock. If, in fact, most professional service corporations go beyond the freedom granted under the Act and impose certain restrictions in a stock redemption agreement, such restrictions are nothing more than those which are contained in thousands of agreements in force in many general corporations.

In its Empey decision, the District Court of Colorado stated, in reference to the Morrissey decision:

It will be observed that the Court, in reference to transferability of beneficial interests, makes no reference to "free transferability," that is, without limitation as to who may purchase. Reference is made only to transfers of beneficial interests without affecting the continuity of the enterprise.

F. Continuity of Life

The Treasury's over-all position on continuity of life is contained in the 1965 Reg. Section 301.7701–2(a) (1). Subsection (h) contains this same basic criterion for professional service corporations plus the following:

If local law, applicable regulations, or professional ethics do not permit a member of a professional service organization to share in its profits unless an employment relationship exists between him and the organization, and in such

case, he or his estate is required to dispose of his interest in the organization if the employment relationship terminates, the continuing existence of the organization depends on the willingness of its remaining members, if any, either to agree, by prior arrangement or at the time of such termination, to acquire his interests or to employ his proposed successor.

It has been pointed out that many a regular corporation vested with a public interest finds itself subject to special regulations which prohibit ownership by a certain class of people. Such provisions, including provisions of state statutes requiring a stockholder to divest himself of the corporate stock on the happening of some contingent event, does not cause the organization itself to cease to exist. Death, insanity, and bankruptcy are normal reasons for the termination of a partnership. This is not true of a professional service corporation. There is nothing in the Florida statutes, for instance, prohibiting a professional service corporation from continuing the salary of an employee who is retired, sick, disabled, or temporarily assigned elsewhere. The Regulations are erroneous when they imply that the corporation status would not survive the shareholder's inability to render service to the company. Actually, continuity of life is one of the main features of the professional service corporation as it exists in Florida and many other states.

Relating to both free transferability of interests and the question of continuity of life, the Attorney General of Florida has ruled[6] that a professional service corporation threatened with a loss of its existence (because either the professional man is no longer qualified to practice in the state or the stock has passed at his death to his heirs who are not licensed in the profession for

[6] Ruling 061–139 of September 12, 1961, Fla. Atty. General.

which the corporation was formed) may amend the articles of the professional service corporation so that it may continue on as a general corporation to conduct other business. Thus, continuity may be possible even for a one-man practice. A professional man who finds on his retirement that he has accumulated substantial retained earnings in his professional service corporation may very well choose to amend the charter of his corporation to continue in general business including real estate investment after he ceased professional practice. His estate or his heirs may profit from the same advantage.

G. Other Corporate Attributes Not Considered in the Regulations

The Treasury Regulations enumerate only six attributes or characteristics an organization must possess in order for it to be taxed as a corporation. There are other factors which should be considered as well. Some of these rights or powers possessed by a professional corporation but ordinarily not by a partnership in all states are:

1. The right to take or pass title to real property in the corporate name.
A partnership cannot take or pass title to real property in its own name in all states. The ability to deal in real estate in this manner, safe from possible annoyances of title problems created by wives, minor children, estates, or dissatisfied partners is a real advantage, available to a corporation but not a partnership. *This also was a feature mentioned in Morrissey.*
2. The right to borrow money without personal liability. Again, this right is a business advantage of a corporation which is not ordinarily available to a partnership.

3. The right to lease property in a corporate name without personal liability.

The comments above are applicable to lease situations.

4. Continuity of name.

It is increasingly apparent that there is a business advantage in having a reputation through a firm name. The assurance that the corporate name will continue in spite of the death or retirement of one of the key individuals is an advantage which often distinguishes the professional corporation from a partnership.

PART TWO

Planning the Corporation: How to Bridge the Gap Between Partnership and Corporation

CHAPTER EIGHT

Documents Needed at Date of Incorporation

A. The Initial Minutes

The content of the initial minutes of the stockholders' meeting and the meeting of the board of directors is most important. Here, the official corporate action will be designated and the board of directors and the officers will be elected. If the corporation qualifies, Section 1244 stock should be issued. Section 1244 stock permits the original stockholder to deduct a subsequent loss (within limits) on the sale or other disposition of the stock as an ordinary loss rather than as a capital loss. It will be here, or in a separate pre-incorporation agreement if the attorney prefers, that the business reasons for incorporating will be stated. The absence of such documentation of business reasons may substantially weaken the corporation's case at some later date. (See Chapter Three.)

B. The Stock Redemption Agreement

A professional corporation relationship needs a stock redemption agreement. It is, in fact, so critical that all stock should be issued pursuant to the agreement. The stock certificates should be properly inscribed to indicate the existence of this agreement.

Why should there be a stock redemption agreement rather than a cross-purchase agreement among the stockholders? Actually, the distinction matters little tax-wise if the corporation is a Subchapter S corporation (electing to tax the ordinary income as a partnership rather than as a corporation), because the tax impact would be the same in any event. Now few professional service corporations will elect Subchapter S when the restrictions contained in the Tax Reform Act of 1969 become effective. Most professional service corporations in the future will pay tax on income as a regular corporation. Therefore, it will prove far more flexible and beneficial for the corporation to purchase stock with its accumulated earnings taxed in a low bracket than to make additional taxable distributions to the stockholders already in a high bracket so that they can purchase the stock. If the corporation redeems the stock pursuant to the stockholder's obligations under a cross-purchase agreement, the redemption may be taxed as a dividend to the remaining stockholder. The transaction will be cleaner if the corporation alone is responsible for the purchase of a stockholder's share under a stock redemption agreement. The main concern should be to avoid a fixed obligation on the part of the stockholder to acquire the stock. Such an obligation will expose not only the remaining stockholders to a dividend tax on the corporation's purchase of stock, but will also expose any payments of severance or retirement pay.[1]

[1] See Rev. Rul. 59–286, CB 1959–2, 103; Glenn–Minnich Clothing Co., T.C. Memo. 1960–207.

In some states there may be restrictions governing the redemption of corporate stock. In such instances the attorney will advise alternate possibilities.

The state statutes or the state professional society may require a professional man to dispose of his stock under certain circumstances, such as at the revocation of his license to practice. Terms of the statute will be considered by legal counsel when they are drafting this agreement.

The plan recommended in this book stresses that the redemption price be set at the book value per share of the stock in the corporation, as set forth in the books and records of the corporation and in the tax returns as filed. The only exception would be the substitution of market values of investments in securities and real estate. The same valuation formula would be the basis for selling stock to a new man coming into the venture or for adjusting shares to give younger men an increased share of the business. Such a formula places no value on goodwill, accounts receivable, or work-in-process. While many professional advisers recommend that the formula for valuing the stock of a professional corporation be designed to maximize the market value per share, and such a formula may have great appeal initially to the founding stockholders, it is likely to prove unsatisfactory in operation. The many reasons for this will be discussed in the next chapter.

But what of the founding stockholder who is surrendering an equitable interest in these assets? Simply expressed, a properly designed over-all program can develop a series of compensating benefits which will replace receivables, work-in-process, and goodwill as funds available for retirement or for estate planning. According to this concept, it is immaterial whether beginning receivables are transferred at incorporation or not. Even if not initially transferred, receivables will

immediately be built up in the corporation and the founders will feel entitled to benefits apart from that of the professional men who subsequently join after the cash-flow "pipeline" is refilled.

These compensating benefits will come from a combination of group life insurance, insured or uninsured pension or profit-sharing plans, disability insurance, and termination benefits under the employment contract. It is the termination benefits in an employment contract which present the possibility for precise planning. The proper use of this instrument can do much to avoid business and tax pitfalls inherent in the professional service corporation. Its potential has been largely overlooked.

In summary, the stock redemption agreement should compute the same value per share for any stockholder, whether he be the founder or the newest man. There should be no variances. It is the terms of the employment contract that will encourage the founding stockholders to surrender any equitable interest in the receivables and other intangible assets. Termination benefits can vary from man to man. New stockholders may receive only a nominal termination benefit, while the founding stockholders' benefits under certain circumstances may be substantial.

This over-all program will be explained later in the discussion of the employment contract and in the next chapter, in which the problems created by cash-basis receivables are discussed.

C. A Memorandum of Understanding

While many professional partnership buy-and-sell agreements place no value on receivables, some do. So that there is no possibility of argument or confusion at

a later date (by the parties themselves, executors of their estates, or their families), attorneys may draw an agreement for all of the parties to sign stating that it was the deliberate intent of all parties that no value was placed on the goodwill, work-in-process, or the accounts receivable. The attorney may wish to recite that receivables, work-in-process, and goodwill are not only difficult to evaluate, but they are in many cases dependent on the continuation of the business for realization. The agreement can state that receivables are not valued so that there will be an incentive for new stockholders and, correspondingly, they are not valued upon one's termination of employment. Such a memorandum will also state that no valuation is given to the goodwill, if any, for it would cease upon the termination of the respective stockholder's termination of employment.

Copies of this memorandum need not be circulated. It is ordinarily signed and retained by the attorney solely in the event that at a later date some individual raises a question of interpretation of the method of valuing stock for sale, or argues that the parties must have forgotten receivables when the documents were prepared.

D. Employment Contracts

As can be seen from the discussion above, the stock redemption agreement is an uncomplicated but essential document providing for the redemption of stock, preferably at the corporation's book value for all book assets except investment in stocks and real estate. The employment contract is more complex. The employment contract should involve itself in the areas normally covered in a partnership agreement, such as notice of

resignation, terms of involuntary termination, and disability.

The employment contract can provide for restrictions on outside activities often placed on the professional man and also require that he remain solvent and in good standing with the profession. It should provide for termination of employment (or the corporation's right to terminate) in the event that these conditions are not met. It may contain an agreement not to compete.

The employment contract can provide for vacations. In fact, vacation rights can become quite involved if the contract permits increasing vacation time based on seniority. The employment contract should provide that the employee will be required to do certain entertaining, maintain a car, and attend business meetings. This will support deductions for employee expenses by the professional man on his personal income tax return. Alternatively, the contract can provide for company reimbursement of some or all of these items if the parties desire.

There is the possibility that the corporation will not have the Subchapter S election to eliminate corporate tax. In such event, the threat of a double taxation can be tempered by a hedge agreement to repay disallowed salaries, expenses, etc., in the event they are deemed excessive by the Internal Revenue Service. Such an agreement should follow the pattern set in the Oswald case.[2] Professional service corporation original bylaws, corporate minutes, and employment contracts can develop this protection against double taxation. Terms of repayment of any disallowed corporate expense should permit repayment over several years. Still, the group must decide whether repayment is practical. This may

[2] Vincent Oswald v. U.S., 49 T.C. 645.

depend on what corporate bracket the disallowance falls into.

Of all the features of the employment contract, none is more important than the termination benefits. The professional man must weigh the termination benefits discussion in this chapter with the problems of cash basis accounts receivable, work-in-process, and goodwill discussed in Chapter Nine.

When planning termination benefit provisions in an employment contract, professional men must consider that termination will occur under any one of four possible circumstances. If proper consideration is given to termination fringe-benefit programs, an employee of a professional service corporation will find that his estate and retirement programs will not have been adversely affected by the loss of receivables. Therefore, the employment contract should carefully consider termination benefits under the following four possible events:

1. Retirement

Of all the ways to terminate employment, this is the most pleasant. The shareholder can expect to have accumulated a substantial retirement fund from a qualified corporate pension or profit-sharing plan. His personal financial obligations will have diminished. The inability to withdraw receivables will have less impact on his retirement program. Still, the founding stockholders may be unwilling to enter into an employment relationship with the corporation without supplemental retirement benefits approximating their loss of equity in receivables. If they are older, or if the retirement benefits are not expected to be substantial, this attitude is understandable.

Pension plans produce larger retirement benefits and require disproportionate benefits for older men. In fairness, older men may recognize this and expect fewer termination benefits under the employment contract. Generally, if

all the professional men are relatively young, or if there will be a generous pension plan for the older men, then the termination benefits on retirement could be nominal or nonexistent. Otherwise, the founding stockholders may insist that additional deferred compensation be provided by the employment contract. Once the termination benefit to be provided under the employment contract is negotiated, the contract should specify that it shall be paid out in a series of installments. It will be deductible by the corporation and taxable to the retiree. Payments should not be related to receivables. In the case of professional men admitted after incorporation (other than by merger of practices), there need be no termination benefits paid on retirement under the employment contract.

The less the organization will be required to pay in termination benefits on retirement, the more attractive will be the group practice for new professional men, and the stronger and more cohesive will be the structure, and this cohesiveness, after all, may be the greatest of all benefits which the founding stockholders can enjoy.

In any event, departure from the group at retirement should not affect the basic premise that the stock redemption agreement ignore any consideration of goodwill, receivables, or work-in-process.

2. Death

Death, particularly a man's premature death shortly after the plan is originated, is a far more serious financial problem than an individual's retirement. If a plan with insurance is involved, the insurance may more than compensate for the loss of receivables in the estate. If a group life insurance program is established, the group life will substitute funds in estate planning for the loss of receivables. (While this cannot be set forth as a contractual substitution, it is an effective replacement for planning estate cash needs.)

3. Disability

A third possibility, other than retirement or death, is that the partner may become disabled. The employment contracts should provide salary continuation until disability

insurance coverage commences. This waiting period could extend for as much as six months. This salary continuation, in the event of complete disability, would represent an effective repayment of receivables and would be deductible by the corporation. Consideration should be given to coordinating benefits under the contract with a general "accident and health" or "sick-pay" plan.

4. Termination of Employment Prior to Retirement, Death, or Disability

Finally, there is the possibility that the partner will terminate relationship with the corporation by voluntarily withdrawing or being involuntarily terminated. The founding stockholders may readily agree that all new men coming into the organization should receive no consideration for receivables on termination because they paid nothing for them coming in. A founding stockholder of the professional corporation may feel, on the other hand, that he has a proprietary interest in the receivables and should receive some valuation at the time of termination. For continuity, many professional men agree that they have more to gain from the solidifying effects of forfeitures by all parties concerned than from the personal protection that they could achieve by being able to receive payment for receivables on their own termination of employment.

Where the founding professional men feel strongly that they should be compensated upon withdrawal, a fixed sum of money may be incorporated in the employment contract as termination benefits payable over a period of months. The stock redemption agreement is no place for such a provision because the resulting formula for the purchase price per share would vary for different transactions and would cause tax problems.

CHAPTER NINE

The Pitfalls Created by Accounts Receivable, Work-in-Process, and Goodwill

Although they do not ordinarily appear in the general ledger or on the tax returns of a professional practice, these assets have a broad and lasting impact on the structure and continuing operation of a professional service corporation. Failure by stockholders of a professional corporation to understand and properly provide for the problems these assets create can seriously affect the stockholders in a surprising number of ways.

These problems become critical at the following times:

A. At incorporation when business assets are transferred to the corporation.
B. When another practice is merged into an existing professional service corporation.
C. When stock is sold to a new man.
D. When outstanding stock is sold by one stockholder back to the corporation or to other stockholders.
E. When the corporation is liquidated.

A. Problems at Incorporation

Shall receivables and work-in-process be transferred to the corporation at incorporation, or should they be retained and collected by the founding stockholders?

The cash-basis accounts receivable of a professional practice may be retained and collected by the unincorporated practice and no harmful tax effects will result. In fact, where the corporation is a result of the combination of several individual practices or partnerships, it is often advisable not to transfer receivables in order to avoid problems of valuation and adjustment of capital equity contributed. However, retaining receivables outside the corporation requires the maintenance of more than one file of accounts receivable and complicates the billing and collecting procedures.

To avoid the problems involved in keeping separate records if receivables and work-in-process are not transferred, the founders may prefer to transfer these assets to the corporation for stock pursuant to Section 351 (which provides that no gain will be recognized if, immediately after the transfer, the transferors own 80% or more of the outstanding shares of each class of stock of the corporation). While Section 351 will effectively prevent taxation on transfer, the subsequent collection by the corporation of those receivables earned by the professional men prior to incorporation may be subject to reallocation by the Internal Revenue Service in an attempt to tax the income to the professional men.

There have been cases which defeated the Commissioner's attempt to charge the cash basis transferor with the income on accounts receivable transferred to a con-

trolled corporation.[1] However, while the courts have been fairly consistent in this area, the possibility suggested by Rooney v. U.S.[2] is that the Commissioner may successfully invoke Section 482 to tax income from receivables to the cash-basis transferor.

All of this could result in the following tax problems:

1. If the stockholders did not elect Subchapter S and the corporation distributes the income when it is received as salary or bonus to the stockholders, the reallocation by the Internal Revenue Service of the beginning receivables transferred to the corporation could result in a double taxation of the income to the professional men (as corporate salary and again as reallocated fee income). The resulting corporate operating loss would be usable only in some future year.
2. If the corporation made a contribution to a qualified profit-sharing plan, the deduction for the contribution to the plan could be threatened if it were not made from current or retained earnings. This would be a problem whether or not the stockholders elected Subchapter S.
3. Collecting accounts receivable personally, while operating expenses are locked into the corporation, can create a timing problem. If incorporation occurs just before the end of the year, this may not be a serious problem because the collections in that short period will be small. If incorporation occurs on the first day of the new year, or shortly thereafter, the collections of old receivables can be balanced by reduced salaries over the next twelve months. The partnership should try to avoid incorporation in the few months prior to the end of its taxable year.

There is a possibility, based on certain tax cases, that in the future the professional corporation can collect

[1] Birren & Son v. Comm., CA–7 (1940), 116 F. 2d 718; and Thomas W. Briggs v. Comm., 15 T.C.M. 440 (1956); Kniffen, 39 T.C. 553.
[2] Rooney v. U.S., CA–9 (1962), 305 F. 2d 681.

beginning receivables and report them as income without the threat of reallocation under Section 482. It would appear prudent now, however, not to transfer the receivables because it will be extremely difficult to develop a tax plan which will relieve the shock of an unexpected reallocation of income at some later day.

B. Problems When Another Practice Is Merged into an Existing Professional Service Corporation

What are the problems of the merged practice as distinguished from the problems of the existing corporation?

Since the pace of business mergers will probably increase, professional men should be aware of these problems:

1. The merging partners or the sole proprietor of an unincorporated practice will undoubtedly receive less than 80% of the outstanding shares of all classes of stock in the existing professional corporation immediately after the transaction.

   Only if the merging practice is many times greater in size than the practice of the professional corporation prior to the merger, could the merging professionals hope to own 80% or more of the combined practice after the merger. While this is tantamount to the minnow swallowing the whale, it has happened in conglomerate acquisitions in recent years so that it is theoretically possible, but highly unlikely. If the merging professionals do not receive the required 80% ownership, the transaction will not qualify as a tax-free exchange permitted under Section 351.

   If the stock, therefore, cannot be issued to the merging group pursuant to Section 351, the transfer

may be a transaction taxable to the new stockholders. In valuing the stock received by the merging group, the Internal Revenue Service may include the receivables, work-in-process, and goodwill of the existing corporation. The taxable gain on the exchange could then be sizable.

2. If both parties to the merger are professional corporations, then the transaction can qualify as a "tax-free" reorganization and escape taxation.[3] However, if an unincorporated practice were to incorporate and immediately thereafter merge, the incorporation and reorganization may be treated as successive steps in a single transaction, which would not be tax-free.

> *How can these problems be faced at original incorporation before anyone knows what problems would be presented if a merger with another unincorporated or incorporated group does present itself at some future date?*

If the merging group is unincorporated, the tax impact will be somewhat neutralized if value placed on the stock of the existing corporation has been low, excluding receivables, work-in-process, and goodwill. (This is another good reason to ignore these assets in any valuation of stock.)

It may be best for the unincorporated group not to merge its practice in exchange for stock, but to retain and collect receivables outside the corporation, buy stock based on the conventional book-value formula, and sign employment agreements that provide for initial compensation reduced in amount by approximately the value of receivables retained. They should sell any tangible business assets to the corporation at book

[3] IRC (1954) Section 368(a)(1)(A).

value or an agreed value as full or partial payment for the stock purchased. For instance, if a two-man partnership plans to merge into an existing professional corporation and the fees receivable of the partnership at the time of the merger are $50,000, the two groups should determine roughly how much of that $50,000 is collectible and over what period of time. Then any otherwise agreed to salary for the merging professional men can be reduced in the early months after merger by monthly amounts which will approximately equal the fees receivable which they have retained outside of the corporation. While reduced salaries can have an effect on payments into pension or profit-sharing plans and other fringe benefit plans, this recommended approach can avoid a very detrimental tax pitfall into which the unwary could otherwise fall.

C. Problems When Stock Is Sold to a New Man

Shall the price per share be computed to include accounts receivable, work-in-process, and goodwill?
What is the alternative to a high price for stock?

A new man can be better attracted to employment if ultimate stock ownership does not require him to pay out substantial amounts of cash early in his professional career when he has little money. The young professional man will realize that he will not be able to recover this investment during his association with the corporation and this can breed dissatisfaction.

The same man will be reluctant to leave the organization if he receives only book value for his shares. Ignoring the receivables and goodwill, both buying in

or selling out, will create the strongest and most lasting type of business structure. When a young professional man is admitted without having to pay for these assets he should expect to leave the same way. This discourages men from leaving the organization because of momentary unhappiness. It also means that the organization does not have to mail checks to its new competitor for a long period of time, thereby helping him reestablish himself in business.

The formula for buying or selling corporate stock should be set at book value (adjusted only for market value of investments in real estate or securities), which, for a cash-basis taxpayer, eliminates goodwill, accounts receivable, and work-in-process from the computation. Most professional partnerships admit new partners into the organization without requiring that they pay for their share of receivables, work-in-process, or goodwill. Professional men should not be distracted because they are now dealing in shares of stock rather than partnership capital accounts. They should not seek a gain above the accumulated book assets of the corporation on the admission of a new professional man to ownership status or the sale of their interest. Those who do seek such a gain may find that they have caused a morale problem in the younger man and tax problems for themselves, including the "collapsible corporation" threat.

D. Problem When a Founding Stockholder Sells His Stock Back to the Corporation or to Other Stockholders

Again, shall the price per share be computed to include accounts receivable, work-in-process, and goodwill?

The founding stockholders may feel that they have some special vested interest in receivables, work-in-process, and goodwill different from any rights of those who may be admitted later. They hesitate to approve a plan which would provide that any future disposition of their own stock would ignore the value of these assets in any redemption agreement. However, if these items are considered in the formula of the redemption agreement, the survivors in the corporation, who have, in effect, purchased receivables, will have to pay the income tax when the corporation collects these same receivables because they have a basis in the stock but not in the receivables. Because the purchase of stock requires a cash outlay which generates no current tax benefit to the purchaser, after-tax dollars will be required for one to purchase the stock. This will be equally true whether the purchaser is a new professional man, an existing stockholder, or the corporation. The unfavorable tax treatment of any stock purchase plan which places high values on stock will require earnings of a far greater sum than the agreed stock valuation formula to provide the necessary after-tax dollars. For example, if one stockholder dies and the agreed stock valuation formula computes a $75,000 purchase price for his shares, then those stockholders in a 50% bracket must earn $150,000 to provide the $75,000 needed to purchase the stock of the deceased stockholder. Thereafter, this payment of $75,000 will provide no tax benefits for the surviving stockholders until the day they terminate employment. (Should they in turn die, the tax benefit would be lost completely because their shares would automatically assume a new tax basis of the fair market value at the date of death.)

To relieve the risk created by a high-valuation formula for stock transactions, such an approach is often accompanied by life insurance to fund the obligation.

It seems completely unwarranted to develop a program which requires nondeductible life insurance premiums on a number of lives to provide the funds to buy one man's stock when those same premiums would be deductible if incorporated in a group life plan or as increased benefits in a pension or profit-sharing plan. As long as the deceased man's estate receives the same dollars, there is questionable benefit to him to couch the payments in such a way as to make it more expensive for the survivors. As a matter of fact, there could be estate tax savings if the benefits are from a qualified employee plan rather than for stock.

The philosophy behind a high stock valuation and related life insurance fails completely when one realizes that stock changes hands for many reasons and, far more often, for reasons other than death. In such cases, the cash surrender value will be of little or no benefit. These other cases are:

1. When a new man buys stock.
2. When a stockholder retires.
3. When a stockholder becomes disabled.
4. When a stockholder terminates his employment.

A low book-value formula for buying and selling stock overcomes all of these situations.

Any plan which places a high valuation on the stock will obviously be a poor plan tax-wise for the buyer. What is not so obvious is the fact that the seller may be taxed on the gain at ordinary income rates, not at capital gains rates, if the corporation comes under the "collapsible corporation" rules.

E. Problem When the Corporation Is Liquidated

On liquidation, what will the tax consequences be on the distribution to the stockholders of receivables, work-in-process, and goodwill?

The two main problem areas involving these assets are:

1. If the professional men continue the practice after liquidation of the corporation, the courts and the Treasury generally consider that the professional firm can have transferable goodwill.[4] Certainly cash-basis accounts receivable and work-in-process will be valued in determining the taxable distribution to the stockholders. Thus, even if the original incorporation was tax-free under Section 351, these assets may not escape taxation on liquidation.
2. There is the strong possibility that the professional corporation may be a collapsible corporation because of the cash-basis accounts receivable. See Chapter Four, Part B for a more complete discussion of this problem.

Can any planning, either at incorporation or at the time of liquidation, minimize the impact?

If the liquidation is planned very early in the stockholders' taxable year, the tax on the distribution of accounts receivable and work-in-process will be minimized because most or all of the receivables will either be collected or be provably worthless by the end of the stockholders' tax year. If the liquidation occurs late in the

[4] Tucker, W. C. v. Alexander, CA–8 (1928), 25 F. 2d 425 Cert. den., 278 U.S. 619.

year, the stockholder may be taxed not only on a full year's cash-basis income, but also on the value of these assets distributed to him.

If planning at incorporation developed a good stock redemption contract and employment contract, it is possible for one or several of the men who plan to continue together to agree to keep their stock and buy out the others pursuant to the terms of these contracts. If the terms prove satisfactory, the threat of taxation—particularly on goodwill—will have been alleviated.

The corporation may be continued by the stockholders after they have ceased active practice together until enough receivables have been collected to take the corporation out of the technical provisions of the "collapsible corporation" rules.

CHAPTER TEN

Additional Necessary Policy Decisions for Preliminary Planning

The professional corporation is not just a tax gimmick. The professional man should condition himself to dealing with the professional corporation as a separate entity. Some of the provisions which were included in his partnership agreement will no longer be applicable. Much advanced planning is needed if the corporate venture is to be successful.

In the two preceding chapters, the most important documents and contractual agreements needed at the date of incorporation were considered along with the serious effects of cash-basis receivables both at incorporation and throughout the existence of the professional corporation. Other major areas requiring advanced planning are the following.

A. The Corporate Name

The state statutes can be very explicit. For example, Florida statutes provide that the corporate name must

include the name of at least one of the incorporators, and the words "Professional Association" or the initials "P.A."

Each professional man will undoubtedly want his name included in the corporate name, but to add names without limit will make the firm name unwieldy. Furthermore, each change in the corporate name undoubtedly will require a charter amendment, which will add to the expense of change in printing forms and letterheads and clerical time required to announce the change to the public and to vendors. Finally, will the name of a stockholder be removed from the firm name if he dies or retires? A positive decision at the beginning can avoid hard feelings later.

There is much to be gained by all from the enhancement of a firm name. The accounting profession has long recognized the value of a continuing firm name. Many professionals now practice in firms bearing the names of the founding partners, all of whom are deceased or retired. The firm name may, in fact, be of such importance that any group seeking to incorporate should pay more than casual attention to these questions:

1. Does the state statute permit the corporation to bear the name of the present partnership, including names of deceased or retired former partners?
2. Must the corporation name be changed if one of the men, whose name is included in the corporate name, dies, retires, or withdraws?
3. What restrictions are contained in the state statutes limiting the descriptive wording in the firm name?
4. What appendage wording must be contained in the corporate name?
5. What will be the cost to change the name, and how often can this be expected, in line with policy already

agreed upon as to inclusion and removal of names in the corporate name?
6. What conflicts exist between the answers above and professional ethics?

B. The Use of a Fictitious Name

Not all state statutes permit practice under a fictitious name. In Florida, the professional service corporation law permits a fictitious name. In that state, however, the statutes permit nothing more than the elimination of the words "Professional Association" or the "P.A." from the fictitious name used by the corporation on its bank account, stationery, billing forms, and other means of identification. By Florida law, the corporation name must include the name of at least one of the professional men involved. Thus, the use of the fictitious name is limited. A name such as the "Florida Medical Group" or the "Tampa Orthopedic Group" would not be permitted as either the corporation's regular or fictitious name. However, the use of a fictitious name still can be of advantage in that it can shorten the name under which the group operates to the same name under which it now practices.

The decision to use a fictitious name will require that the corporation very meticulously follow its state law for qualifying to practice under a fictitious name. Anyone considering the use of a fictitious name should study the following questions:

1. Does the State Professional Service Corporation Act permit practice under a fictitious name?
2. Does the federal or state professional society's ethics committee permit, or possibly even require, operation under a fictitious name?

3. Is there any business or psychological advantage to operating under a fictitious name?

Some writers on the subject advise against use of a fictitious name because they feel that such action reduces the corporate characteristics of the organization and should be avoided while the tax status of the corporation is under attack.

C. Choosing the Stockholders, Directors, and Officers

Who can be a stockholder, director, or officer in a professional service corporation? The answer depends entirely upon the individual state law and the decisions of the specific professional society.

Many state professional service corporation laws permit even a single professional man to incorporate. Notwithstanding, the attorney may recommend that outside qualified professional men be elected as officers and added to the board to bring the number up to three, if less than three men plan to practice together, in order to establish centralized management and to create a more corporate-like structure.

As the organization grows in the number of professional men a clearer indication of centralized management can be achieved. If more than ten professional men practice together, the stockholders must be limited to ten if they are to take advantage of the Subchapter S election.[1]

[1] IRC (1954) Sections 354 and 361.

D. Whether or Not to Elect Subchapter S Tax Treatment

Before any amendment by the Tax Reform Act of 1969, the tax advantages and disadvantages of a Subchapter S election were apparently so equally divided that advisers to professional groups differed widely on the question of whether or not to elect Subchapter S. The advantages and disadvantages of a Subchapter S election must be understood and weighed in each individual case.

With the changes affecting Subchapter S corporations contained in the Tax Reform Act of 1969, a new set of factors now seriously affects the decision of whether to elect or not elect Subchapter S.

What are the reasons apart from the new tax law for retaining the regular corporate tax status?

Advocates for retaining the regular corporate tax status give the following arguments:

1. If there is a state income tax and the state tax law does not permit a Subchapter S treatment, a Subchapter S election will result in two different tax treatments and increased bookkeeping.
2. Some or all of the professional men in the group may enjoy such an extremely high income that, even after making the maximum contribution allowable to a pension or profit-sharing plan, there will be additional income available to invest. If so, the advantage of the lower corporate tax bracket becomes attractive.
3. There may be a real need to accumulate earnings in the business. If the new corporation accumulates

needed working capital to fund a stock redemption agreement, or plans the construction or purchase of its own office or medical building, or plans extensive remodeling and additions of equipment, then this will permit the corporation to take advantage of lower corporate tax brackets. In the corporate plannings, however, a separate corporation to build, furnish, and equip an office building or medical clinic and lease the property to the professional corporation is an alternative possibility that should be considered. (Such a separate corporation, involved with office facilities, has particular merit if some or all of the present professionals wish to enjoy it as an investment unavailable to those who may be admitted subsequently as shareholders, and if the accumulation of earnings otherwise will be so substantial that retained earnings would create a possible barrier to a young professional man wishing to buy into the corporation.)

4. If the corporation elects Subchapter S tax treatment, any premature disposal of stock, including the sale of stock to a new professional man admitted to the group, can result in a recapture of investment tax credit.[2]

If the corporation operates without benefit of Subchapter S, what disadvantages will it face?

1. The accumulation of assets in the corporation to save taxes may well be beyond the ability or desire of some of the shareholders. If the shareholders must withdraw the funds for personal needs, the apparent tax advantage of the non-Subchapter S corporation evaporates. In most cases, the needs for cash on the part of some or all of the men in the group means that they may not even be able to take full advantage of

[2] Treas. Regs. 1.47–4(a)(2).

the potential of a pension plan, a profit-sharing plan, or a combination of both.

2. Without Subchapter S, the professional man risks double taxation, if his salary is deemed excessive, or if any additional compensation above base pay is considered to be a dividend rather than a bonus. There are those who feel this risk is minimal since the professional could point to comparable incomes by similar professionals. Still, the professional men must be advised that the question of whether all forms of compensation to a professional man, including contributions to a deferred employee benefit plan, will be deemed excessive has not yet been answered by the courts in a professional corporation case. However, year-end or periodic discretionary bonuses to stockholders are closely akin to dividends. The distinction often is merely one of bookkeeping. The Research Institute of America, in its special study *Reconsider Now Practicing as Professional Corporation* (June 12, 1969, page 10), states:

While a professional may have earned substantial fees as sole proprietor or partner, it isn't certain that the same amount will be accepted by the Treasury as a reasonable salary to be paid to him as an employee of his professional corporation. For example, a professional may net $75,000 a year from his individual practice. But if he becomes a professional corporation, the Treasury may not accept $75,000 as a reasonable salary. It may argue that a corporation wouldn't be likely to pay an amount of compensation that leaves no profit for itself. A district court specifically raised this danger with respect to a business corporation. Operating as a pseudo-corporation [Subchapter S] avoids this danger. . . .

3. Depending on the nature and size of the practice, many professional corporations are subject to the challenge that the income is from personal service contracts. This type of income is "personal holding

company" income.[3] The corporation would then have the dubious choice of paying out its retained earnings in the form of a dividend (a double taxation, not a savings) or paying a personal holding company tax which would be assessed in addition to the regular corporate tax.

4. The effect of accumulation of retained earnings means that each of the stockholders will pay a second tax at capital gains rates when the professional man liquidates or sells his stock in the corporation, or at ordinary tax rates if the corporation is a collapsible corporation or if accumulated earnings are distributed as a dividend.
5. Accumulation of retained earnings places a strain on new professionals buying into the venture. The new stockholders are forced to pay out after-tax money for assets, which they cannot recover during their active professional lifetime, in order to buy into the venture. This may prove most distasteful to the incoming professional man. The damage that can be done here is often reason enough not to accumulate investment type of assets in a professional corporation.
6. Possible subsequent liquidations, mergers, etc., are more difficult to manage because unrealized receivables and accumulated surplus must be considered. The collapsible corporation problem can be more acute if there are accumulated earnings.
7. First year depreciation and investment tax credit do not pass through to the professional men.
8. In most instances, the professional corporation will not need to retain more than $100,000 of earnings. Therefore, the corporation with retained earnings of more than $100,000 may be advised to elect Subchapter S, or attempt to justify a complete distribution of all corporate earnings as year-end bonus, or make a contribution to a deductible deferred benefit plan to avoid a Section 531 penalty.

[3] IRC (1954) Section 543(a)(7).

Conclusion

One argument for the Subchapter S election is removed if the particular professional practice operates in such a way that there is little risk of a Treasury attack as a "personal service corporation." There will be no risk at all if each of the stockholders owns less than 25% of the stock.[4] Thus, the larger group can choose to be taxed as a regular corporation with less risk than the smaller group.

The practical fact is, however, that few professional men will want to accumulate savings in the corporation. Either they will need the money for current living expenses or have individual preferences for investment of the accumulation that inevitably will conflict with the preferences of the other stockholders. The frustration inflicted on newly admitted members of the stockholder group by forcing them to buy investments is very real.

The discussion may be academic now that the Tax Reform Act of 1969 has finally been enacted by Congress, effectively restricting deductions for a Subchapter S corporation to that allowed a self-employed person under a Keogh plan (10% of earned income up to $2,500) if the professional man owns more than 5% of the stock. While other valuable fringe benefits (such as deductible group life, group health, disability insurance, etc.) are still available to a Subchapter S corporation, most professional men will want the right to a deductible contribution to a pension or profit-sharing plan well in excess of $2,500 per person. This change appears intended to urge the professional corporation to abandon the Subchapter S election. Will the Treasury then have run the professional men into a professional corporation *cul-de-sac*? The corporation cannot liquidate without facing the problems previously discussed re-

[4] *Ibid.*

lating to collapsible corporation treatment and the inclusion of receivables, work-in-process, and goodwill in the computation of the taxable gain on liquidation.

The advantages of the Subchapter S election are so impressive that professional men should view its imminent loss, due to the new provisions in the Tax Reform Act of 1969, as a dangerous development that must be weighed carefully before final decision to incorporate is made.

E. Treatment of Accounts Payable at Incorporation

If the accounts payable of a cash-basis partnership are assumed by a corporation in a Section 351 transfer, the corporation cannot deduct the accounts payable when paid nor will the payment result in a deduction for the partners of the old partnership.[5] Thus, a deduction can be lost entirely. It is important in the incorporation of a business that the corporation does not assume the accounts payable but that the partnership continues for the purpose of paying all outstanding indebtedness incurred.

F. Election of a Corporate Fiscal Year

The problem of accounts receivable at the time of incorporation indicates the possible need to cut off the first fiscal period of the corporation after a few months of operation.

As previously mentioned, if the old partnership is on a fiscal year, there could be a serious "bunching" of income problem, and careful selection of a corporate

[5] Holdcroft Transportation Co. v. Comm., CA–8 (1946), 153 F. 2d 323.

fiscal year could play an important part in minimizing the impact of that problem.

Corporations are permitted to elect a fiscal year. It is tempting to elect a year ending other than the calendar year for a Subchapter S corporation. This permits some maneuvering for deferral of taxable income and permits the professional man to know his taxable income in advance so he can control his outside taxable income and deductions for the year. On the other hand, if the corporation is not to be Subchapter S, the corporation may choose to close its fiscal year in the first short period of operations after the corporation has earned $25,000. In this way, the first $50,000 of corporate earnings may be taxed in the minimum corporate tax bracket.

CHAPTER ELEVEN

Other Decisions and Action Before Incorporation

This chapter is included with a word of caution. It is impossible to make this an all inclusive checklist of the planning which should precede incorporation. The reader should stay alert to the possibility that other important steps should be taken to insure the success of the corporate venture. Here then is a suggested list of some items requiring action or decision prior to incorporation.

A. Charter, Bylaws, and Other Documents

If a partnership agreement exists, it should be reviewed, particularly those sections pertaining to dissolution. The pre-incorporation minutes should be complete and include the discussions of the business purposes for forming the corporation. A plan to issue stock under Section 1244 of the Internal Revenue Code is

almost always desirable. There are no bad side effects of a Section 1244 stock issue. It is easily accomplished (a properly drawn paragraph inserted in the minutes) and can be of tax benefit to a stockholder if he suffers a tax loss on the ultimate disposition of the stock.

Consideration should be given to including in the bylaws a requirement, similar to that in the Oswald case,[1] that salaries disallowed by the Internal Revenue Service as being unreasonable must be repaid to the corporation. The stock redemption agreement, memorandum of understanding, and employment contracts should be drafted and approved. Determine who will be shareholders and how many shares will be issued to each. Will stock be par or no-par value? Stock certificates should be prepared with any transfer restrictions noted thereon.

B. Stationery, Forms, etc.

Printing will take more time than professional men may expect. It will first be necessary to review all of the forms presently in use in the office. The printer should be called in and the forms reviewed for standardization and appearance. The order should be placed for delivery prior to the date the corporation expects to commence business. If voucher-type checks are to be used, the design should be approved at an early date. This will also require a decision as to the bank to be employed, the number and type of bank accounts to be used, the corporate name, and the number of signatures that will be required.

[1] Vincent Oswald v. U.S., 49 T.C. 645.

C. Telephone and Utilities

Rearrangement of utilities, especially telephone facilities, may be required. The telephone listing in the directory may need to be changed. In any event, utility companies should be notified that service should be billed to the corporation after the date the corporation begins business, and all of the utility company records should be changed accordingly. Because utility companies do need time to make any necessary changes, decision on the status of the telephone and other utility services should be determined at an early date.

D. Professional Liability Insurance

Professional liability insurance in some instances is becoming much more difficult to obtain. Before incorporation, the professional men should be assured that they will be protected under a professional liability insurance policy after the corporation commences operation. It is advisable that each individual be covered as well as the corporation. In some states, such as California, the professional service corporation statutes require the professional corporation to carry a stated minimum of professional liability insurance.

E. General Insurance

The general insurance agent representing the current firm should be notified that the insured will become a corporation after the set date for commencement of

corporate operations. Proper coverage should be assured on the first day of the new business operation.

F. Announcements

The professional men should decide if professional ethics will permit an announcement. If professional ethics do permit an announcement, decision as to the extent of the announcement and the wording should be made, and arrangements for printing and mailing should be made in advance of the date of the commencement of the business activities of the corporation.

G. Opening the Bank Account

It will be necessary to operate under new bank accounts for the corporation. Before incorporation, the decision must be made as to who will be authorized to sign on the bank accounts. Resolutions, signature cards, etc., must be obtained and completed so that the bank account will be ready.

H. Application for Federal Employer Identification Number, Form SS-4

This application should be submitted as soon as possible because there will be a period of inconvenience if operations begin before the identification number is received and the depositary receipts are forwarded by the Director of Internal Revenue. If withheld payroll taxes are due before the receipt of an identification number or the depositary receipts, a payment should

be submitted in a timely manner to the proper collection center with a transmittal letter explaining the facts.

I. Application to State Taxing Authorities

If required, application forms should be submitted to state taxing authorities, including corporate income tax, franchise tax, tangible and intangible tax, sales tax, occupational licenses, narcotics licenses, etc.

J. State Unemployment Compensation Forms

Each state will tax for unemployment compensation. The form required by the state should be submitted as soon as possible in order that reporting forms supplied by the state will be made available as soon after operations begin as possible. If there is an experience rate available to the existing partnership, the transfer of that experience rate to the corporation should be made, if permitted, by filing the proper forms.

K. Subchapter S Election

If the corporation desires to take advantage immediately of a Subchapter S election, the election must be made no later than one month from the first day the corporation either has assets, has shareholders, or begins doing business. The election will require timely filing with the signature consent of each stockholder. The corporation must be alerted to have each new shareholder hereafter sign consent to the election in order to keep the election in effect.

L. Transfer of Assets and Liabilities under Section 351

Certain assets and liabilities of the predecessor operation will be transferred under Section 351 to the corporation at the beginning of operations. Briefly, Section 351 provides that there will be no gain or loss recognized on the transfer if the transfer is solely for stock and/or securities of the corporation and if immediately after the transfer, the transferors own over 80% of all classes of stock outstanding. The transferors are required to submit a statement of information in their individual tax returns in the year of transfer.[2] The statement must contain a description of the property transferred, a description of the stock or securities, received in exchange, a statement of the fair market value of the securities or stock, a statement that no money or other property was received, and a statement of any liabilities assumed by the corporation.

Legal counsel will advise whether deeds, bill of sale, or other documents are necessary to affect the transfer. Loans, leases, and mortgages should usually be assumed by the corporation.

Receivables for cash-basis fee income, as we have mentioned, may or may not be transferred to the corporation. If they are transferred, the ledger cards should indicate that the billing now is in the corporate name. If receivables are not transferred, new ledger cards should be set up on the first day of business and charges for all new work after date of incorporation should be posted to the new ledger cards. The two sets of receivable records should be maintained as long as the outstanding receivables of the prior business remain outstanding.

[2] Treas. Regs. 1.351–3.

As previously explained, cash-basis payables for expenses should not be assumed by the corporation but should be paid by the prior business entity. Thus, it will be necessary to keep that entity active for a period of time while receivables and/or payables are cleared.

M. Opening New Books

A new set of books should be opened for the corporation. Very few account changes will be required. There will be no accounts corresponding to the partnership accounts for partners' drawing or partners' capital accounts. Instead there will be expense accounts for officers' salaries and there will be an account for dividends paid. There will be an account for capital stock, paid-in surplus, and if a Subchapter S corporation, accounts for the undistributed earnings of each stockholder. If the corporation does not elect Subchapter S, there will be an expense account for federal income tax and a liability account for income tax payable.

If a pension or profit-sharing plan is adopted or if group medical, group life, or disability insurance is provided, deductible expense accounts for these items should be provided in the chart of accounts.

Remember that all of the professional men are now employees and subject to the same payroll taxation and workmen's compensation insurance as all other employees.

N. Notifying Employees

Employees should be notified well ahead of the change that the practice will be conducted in a corporate form after a certain date.

O. Notifying Vendors

Vendors should be notified in advance that the practice will be conducted in a corporate form after a certain date, and the vendor should be requested to change its records so that it bills the corporation thereafter. If the vendor fails to comply, the request should be repeated.

P. Termination of Self-Employed (Keogh) Plan

If a self-employed (Keogh) plan is currently in force, consideration should be given to the disposition of the plan. It will probably be advisable to keep the plan alive, but inactive, rather than terminate and distribute—with the resulting tax penalties. If the plan provides for insurance funding, the insurance specialist should be consulted.

Q. Target Date to Commence

There have been instances when a group incorporated late in the calendar year, made the Subchapter S election, created and contributed to a fixed benefit pension plan, elected a calendar year ending, and claimed a tax deduction in that current year. Where the professional men have but a relatively few years before retirement, a target date prior to December 31 will squeeze one more year of tax-deductible contributions into the plan. Haste may be excusable in such a case. However, each step outlined above is necessary to accomplish the goal. It would not work with a profit-shar-

ing plan or a money-purchase pension plan, for instance, because there would be little or no compensation as a basis for contributions.

A target date of January 1 will save payroll tax and insurance duplication and also will simplify bookkeeping. It permits one's reviewing operations for several months before choosing the corporation's fiscal year. If the new corporation begins in the last few months of the year, the individuals may collect the bulk of their old accounts receivable before their taxable year ends. If they do this, they will be taxed on this income with no offsetting expense of operations during the period when deductions are claimed by the corporation unless they elect Subchapter S and close the corporation's fiscal year concurrently with their own. Because there may be good reasons not to elect Subchapter S, it may be best for one to begin corporate action either very late in the year before the collection of the receivables is material or early in the next year when the receivables can be offset by reduced or postponed salaries to the professional men.

The most important thing is not to rush into a corporation without planning. Preferably, there should be at least two or three months between the initial planning and the commencement of the corporation.

R. W-4 Payroll Forms

Each employee is required to submit to his employer a Form W-4 reporting his name, social security number, and number of dependents. The forms will be retained in a permanent file in the office. Since the professional men will now be employees, they too should submit W-4 forms.

S. Withholding Tax for the Professional Men

The professional men will now be subject to withholding tax. It is probable that the tax tables will not result in a sufficient withholding to offset the tax due on the federal return. The professional man should either revise his estimate to pay in the expected difference or should instruct the corporation's bookkeeper to increase his withholding to an amount sufficient to pay the tax for the year.

CHAPTER TWELVE

Special Problems for New Business Combinations

The professional service corporation has provided an impetus for individuals to join together in new and larger professional entities. In just one office of our firm in the month of December 1968, we were simultaneously involved in the formation of three new professional corporations: one for three doctors who previously had practiced separately as sole proprietors; another, for a new professional corporation composed of a two-man partnership plus a sole proprietor; and the third, the consolidation of two previously independently operating professional service corporations. These new business formations have special problems. Some of the problems are set forth in the following discussion.

A. Selection of Professional Advisers

It should be expected that the separate parties to the proposed new venture will not have employed the

same professional advisers. Such relationships are not easily broken. The choosing of an adviser to implement the professional corporation does not automatically exclude the adviser's competitors from rendering other later services to the corporation. It will be awkward, though, to involve too many in the planning stage.

This book indicates that the design of deferred employee benefit plans and fringe benefit plans should follow basic corporation planning and decisions. Too often trouble has developed when this corporate preliminary planning has been neglected. The outside advisers who must be selected are:

1. Attorney
2. C.P.A.
3. Banker
4. General Insurance Agent
5. Printer

For later advice in the design and structure of employee benefit plans, the group may wish to turn to one or more of the following:

1. An actuary, or employee benefit specialist
2. An investment counselor
3. A life insurance specialist

B. Allocation of Stock Ownership and Salary to the Professional Men

In the incorporation of an existing partnership, the relationships of income as they existed in the partnership will basically be carried forward into the corporation salary and stock ownership structure. However, there is no prior history to assist a new business combination. The first action should be to determine the

relative earning power of each professional man. The C.P.A. selected by the group should make an independent examination of the records of each professional man or each group in the new venture. This would not necessarily require a certified examination.

Gross fees produced by each professional man for the past two or three years and for the interim period to a current date immediately prior to the feasibility study should be presented for all to review. They should also review net earnings as reported on tax returns, Schedule C, or Form 1065. Any unusual deduction, such as rent on a personally owned property, a self-employed (Keogh) plan deduction, etc., should be explained. The report should detail the number of personnel employed in each venture, their duties and gross pay. Prior arrangement with employee professional men regarding future earnings, partnerships, etc., must be disclosed.

If all of the professional men enjoy relatively equal earnings, the new venture is much more likely to be successful. If the earning relationships are disproportionate, compromises will be necessary. Each party to the venture early in the discussion must search his own attitudes to see that he will be perfectly willing, in the long run, to live with the negotiated earnings relationships without permitting jealousy or rancor to affect the relationship. A harmonious relationship is essential for the long-term success of the venture.

C. Credit for Assets and Liabilities Transferred to the Corporation

The professional men ordinarily are not concerned about book value differences in fixed assets. Usually,

these are contributed and represent a varying basis in the stock held by each. When one has an unusually elaborate office setup, however, this may be taken into account. One way to take it into account would be for that professional man to borrow on the assets, thus reducing his equity in them. When the related loan is assumed by the corporation, its repayment will come from corporate funds. (Be sure the loan does not exceed the tax basis in the assets.)

If one of the professional men owns his office building, a lease with satisfactory rent terms must be negotiated.

Since a multitude of possible variations of asset and liability situations could exist, it is not feasible in this study to construct every possibility and suggest a solution. The business assets other than cash and fees receivable normally are relatively small in monetary value. The important thing is for the C.P.A. to bring the facts to the group's attention at an early date.

D. Treatment of Accounts Receivable at Date of Incorporation

The C.P.A., in his review of the records of the various parties to the incorporation, should age and total the receivables of each of the new participants. It may be helpful for him to group receivables into broad categories, if this is possible. If the total receivables of each participant indicate a reasonably proper relationship to the agreed stock and salary distributions, then it may prove easier to transfer all of the receivables to the new venture than to leave the receivables outside the venture for independent collection and distribution. The bookkeeping problems of separate record-

keeping will be sizable. The threat of a Section 482 reallocation of transferred receivables has been previously discussed. If there is some doubt in the minds of the various participants as to collectibility, the receivables of each can be coded onto the accounts receivable cards, and the C.P.A. can periodically make a review and report actual collections. Any substantial discrepancy could then be adjusted by a special bonus.

E. Name of the Corporation

It should not be surprising that this can be one of the most delicate problems in the initial survey of feasibility. The obvious importance of our own name to each of us can make the order in which the names of the professional men appear in the firm name of the new corporate venture a decision which should not be made lightly. It is a decision, however, that should be made and finalized early in the feasibility study so that forms and other needed procedures can be undertaken.

F. Office Location, Space Design

Again, the new corporation, unlike an existing partnership, must often begin practice from several space locations, the prior practices operating from locations which are subject to varying terms and lengths of leases. Ordinarily, it will prove more efficient and economical to consolidate offices as soon as practical. However, it is very possible that the initial operations may continue for an interim period at each location. The patients' or clients' convenience must also be considered. If the practice is dependent on the geographical

location, it may not be possible to consolidate into just one location. In any event, the final goal of the group should be to consolidate as much as possible and plans should be made accordingly. This will require the determination of the ultimate location for the corporation, the acquisition of sufficient space, and the design of that space. Plans should be made, meanwhile, to operate as efficiently as possible from the multiple locations. Record-keeping and communication become a problem. The nature of the practice may make it necessary for the professional men to maintain accounts receivable files and billings from each individual location. If possible though, the accounts receivable should be consolidated. In any event, the general bookkeeping should be consolidated in one location, preferably the address of the ultimate central office. As long as multiple offices exist, it may expedite matters for the participants to provide a bank account at each location for depositing fees collected and for paying for special invoices, purchases of postage, travel, and other items that require the availability of a check to be more rapid than one provided by means of a central bookkeeping location. The design of the flow of bookkeeping information from the branch offices to the central bookkeeping office should be planned in advance or the clerical employees will meet with confusion at the date of incorporation.

G. Insurance Programs

Professional insurance coverage and general insurance coverage should be consolidated and the agent or agents who will write the insurance for the new corporation should be appointed as early as possible. If

several agents are to be used, they should be asked to work together to produce the best coverage for the group. Again we should point out that professional liability insurance for the corporation and all the individuals should be assured before the venture is finalized.

H. Telephone, Utilities, etc.

An elaborate telephone system may be required to cover the various offices. In any event, listings will change and the service requirements may be expensive. The telephone company should be consulted immediately so that work can progress to smooth the transition.

I. Integration of Clerical Personnel

An early study should be made of the clerical talent available and the gross wages of each. The rates of pay to the employees should be rescheduled so that there are no inequities in the new corporation. This will undoubtedly involve pay increases in certain areas, and this will represent an added expense. When the offices are consolidated, there may be clerical savings resulting from more efficient utilization of talents. Out of the group, the most efficient bookkeeper should be selected and given the task of keeping the corporate books and administering the reporting system from the branches.

It is more difficult than most professional men would expect to accomplish a smoothly running consolidation of several practices into one corporation. It involves not

only the problems inherent in any professional service incorporation, but also the problems mentioned above. However, if these problems are recognized early and sufficient time is given to them, they can be overcome.

PART THREE

Corporate Pension or Profit-Sharing Plans: How to Choose a Plan and How to Select Its Features

CHAPTER THIRTEEN

Is a Professional Corporation Pension or Profit-Sharing Plan Better Than a Self-Employed (Keogh) Plan?—Keogh Plan Limitations

Any discussion of self-employed plans (referred to hereafter as Keogh plans) must include an understanding of the term "owner-employee." An owner-employee is a sole proprietor or a partner who owns more than a 10% interest in the partnership.[1] For large law practices, medical clinics, etc., having no owner-employees, special rules make a Keogh plan more attractive than it is for the smaller group. Still, even with these added advantages, such plans are far less favorable than corporate plans.

Basically, the advantage of a professional corporation pension or profit-sharing plan is that such plans are not encumbered with the limitations placed on Keogh plans. These limitations are:

[1] IRC (1954) Section 401(c)(3).

A. Limitations on Amounts That Can Be Contributed

Under the Keogh plan, the amount of money which a professional man can set aside is definitely limited. It is possible that a young professional man who is very successful in his investment program under a Keogh plan can accumulate enough money in his professional lifetime to provide substantial retirement benefits for himself. Still, the maximum annual investment which a self-employed owner-employee can contribute for himself is the lesser of 10% of his earned income or $2,500.[2] Contributions for partners who are not owner-employees may exceed the $2,500 limitation. However, while the contribution may be in excess of $2,500, the allowable tax deduction is still a maximum of $2,500. This places serious restrictions on the possibility of funding for a sizable annual retirement income.

For Subchapter S corporations, the Tax Reform Act of 1969, for years beginning after December 31, 1970, effectively restricts contributions to a corporate plan to that permitted under a Keogh plan by taxing excess contributions (over the 10% of compensation, or $2,500) to any shareholder owning more than 5% of the corporation's stock, but no such limitation exists for the corporation not electing Subchapter S.

B. Limitations on Investment Opportunities

Under the Keogh plan, the professional man will find far less flexibility in investment opportunities. As a general rule, he contracts with a bank, an insurance company, or a mutual fund to invest his funds for him.

[2] Treas. Regs. 1.401–12(i).

If the fund of his selection is successful, his investment will be successful, but he will not find the flexibility in investment that is possible through an auxiliary fund of a pension plan or through a profit-sharing plan.

If the partnership is a large group with no owner-employees in the plan, an individual rather than a bank may be the trustee, and the investment flexibility will be the same as in a corporate plan.

C. Limitations on Deferred Vesting

The Keogh plan covering an owner-employee must provide for immediate vesting for all employees.[3] On the other hand, if there are no owner-employees covered in the plan, the vesting rules are as those for corporate plans. In a corporate pension or profit-sharing plan with deferred vesting, the professional man should benefit through the years by forfeitures of employees who leave employment before their rights have become fully vested. This can be substantial in the aggregate. Furthermore, immediate vesting offers no incentive to key employees to stay with the firm.

D. Tax Advantage to Withdrawal of Funds

The provisions of the Tax Reform Act of 1969 may narrow one big tax disadvantage of the Keogh plan. Section 515 of the new Act taxes as ordinary income the portion of a lump-sum distribution from a qualified employee plan which was contributed by the employer after 1969 (but it permits seven-year income averaging). Any contributions made prior to January 1, 1970, and increases in the plan due to income or appreciation

[3] Treas. Regs. 1.401–12(g).

would be taxed as capital gain. The 1954 Code provided that an employee on termination of employment will receive capital gain treatment on the complete withdrawal of funds within one year from a corporate pension or profit-sharing plan on termination of service.[4]

Even on one's retirement, the withdrawal of funds from the Keogh plan will be taxed at ordinary income rates, subject to a five-year averaging.[5] The detrimental tax treatment will often force the professional man to elect to take payments out of the plan in the form of an annuity, and an annuity is considered by many a very poor investment in a period of inflation and rising price levels.

E. Specified Ages When Withdrawal Is Permitted

The Keogh plan penalizes any withdrawal by the professional owner-employee prior to age 59½, except for death or disability. Financial hardship or early retirement withdrawals are not permitted without penalty.[6] Conversely, if the professional owner-employee is still vigorous and productive at age 70½, distribution must begin. Corporate pension or profit-sharing plans are far more flexible.

If there are no owner-employees who are covered in the Keogh plan, this rule does not apply. However, the tax treatment upon withdrawal still makes the plan less attractive than a corporate pension or profit-sharing plan.

[4] IRC (1954) Section 402(a)(2).
[5] IRC (1954) Section 72(n).
[6] IRC (1954) Section 72(m).

F. Inability to Qualify for Death Benefit Exclusion

Payments to survivors of self-employed persons will not qualify for the $5,000 death benefit exclusion which is available to survivors of employees under the regular pension and profit-sharing rules.[7] Furthermore, the estate tax exemption which is available to the estates of deceased employees (for proceeds received by beneficiaries under a qualified plan attributable to the employer's contributions) does not extend to beneficiaries under a Keogh plan.

G. Limitations on Ability to Integrate with Social Security

Rules for integrating a Keogh plan with social security are so restrictive that they eliminate integration as a possible feature for most plans.[8] However, for a Keogh plan with no owner-employees, the rules for integration with social security are the same as those for any corporate pension or profit-sharing plan.

Any discussion of Keogh vs. the professional corporation would not be complete without our pointing out that the professional men's decision to adopt a Keogh plan and remain as a partnership or sole proprietorship will not give them the advantages of limited legal liability or the opportunity to institute group life, group medical, and group disability insurance coverage or sick-pay plans as would be the case if they took the route of the professional corporation.

[7] IRC (1954) Section 101(b).
[8] IRC (1954) Section 401(b)(6).

CHAPTER FOURTEEN

Basic Differences Between a Pension and a Profit-Sharing Plan

The best plan or combination of plans will be produced only by one's knowledge of the potential of each type of possible plan. An adviser must resist the inclination to force every professional group into his favorite benefit plan.

A discussion of the three most commonly used plans may assist professional men in this critically important choice:

A. Fixed-Benefit Pension Plans

A fixed-benefit pension plan is a plan which provides a retirement benefit usually stated as a percentage of average annual compensation. Such a plan requires contributions actuarily calculated which will provide a sufficient fund for one to buy an annuity or otherwise assure the benefit payments guaranteed under the plan.

Generally, forfeitures serve to reduce the corporation's next contribution to the plan.

There may be variations of this type of pension plan. A variable annuity plan may involve an element of growth potential. Length of service may be recognized. Vesting rights may vary and death benefits may or may not exist. These refinements are considered only after the broader decision to adopt a pension plan is made. To meet his retirement needs, the pension plan may prove to be the only effective means of generating sufficient contributions for the benefit of the older man. A fixed-benefit pension plan will favor the older men in the group, while a profit-sharing or a money-purchase pension plan will generally appeal to the younger men.

B. Profit-Sharing Plans

A profit-sharing plan usually allocates any contributions into the plan in a ratio of each covered employee's compensation. Thus, age is usually not a factor nor is length of service. Contributions are made only from current earnings or accumulated earnings. Ultimate benefits are not guaranteed. Forfeitures are usually credited to the accounts of the remaining employees. However, the Tax Reform Act of 1969 will not permit forfeitures to be credited to stockholder-employees of a Subchapter S corporation. Since under this plan no retirement sum is predictable or promised, there is no need for the expense of actuarial computations. Contributions into the plan may be determined annually by the board of directors and are limited only by profits available and a restriction that contributions may not exceed 15% of covered compensation.

C. Money-Purchase Pension Plans

The money-purchase pension plan is very much like the profit-sharing plan in that contributions are usually calculated as a percentage of the employee's compensation. The employee's age is no factor, and there is no guaranteed retirement benefit. However, the plan has very little flexibility in that the guaranteed percentage contribution must be made each year, whether there are profits or not. As with a pension plan, the money-purchase plan will permit a larger contribution than the maximum 15% of compensation permitted under a profit-sharing plan. Vesting and forfeiture requirements follow general pension plan provisions.

The advantage of the money-purchase plan is that it allocates contributions in the same manner as a profit-sharing plan, yet is not limited to 15% of compensation or to the existence of profits, like the profit-sharing plan.

D. Summary

Contributions to a fixed-benefit pension plan are not limited to a percentage of compensation, but to that amount required actuarily to provide the guaranteed benefits. Contributions under a profit-sharing plan are limited to 15% of compensation. If both a pension and a profit-sharing plan are in force, the combined contributions to the plans may not exceed 25% of compensation. If only a pension plan is in force, however, the contribution may exceed 25%, if that amount is required. Professional practices can prove to be very volatile organizations. Professional groups lose members, add

members, dissolve, and merge. Pension and profit-sharing plans should be designed with this volatility in mind. When two groups merge or consolidate, the plan belonging to one of the professional corporations may be totally unacceptable to the other group. The professional men must foresee that for all these reasons a plan may be terminated before a ten-year period expires, or that a member of the corporation may terminate his association within that period of time. Therefore, if the choice is a pension plan, the benefits under the plan should not be set or increased to the point that they are subject to restrictions in the regulations.[1] These regulations (which must be written into every pension plan) provide that in the event of early termination, the benefits which may be withdrawn by certain of the higher paid employees will be limited to either (1) a lump sum of $2,000, or (2) 20% of compensation up to $50,000 per year, whichever is greater. Rather than provide benefits in the pension plan which exceed this limitation, the professional corporation should consider adding a profit-sharing plan.

When the key men in the organization have relatively few years before retirement, the fixed-benefit pension plan can provide substantial benefits in relatively few years. Even in such cases, the group should consider the impact on the younger men. Of the three, the fixed-benefit pension plan is the most likely to cause friction and the most expensive to administer. Still, the fixed-benefit pension plan may be the only way to provide adequate retirement income for an older man. For harmony, the older men may compromise current salary or termination benefits in their employment contracts in return for increased pension benefits.

Some advisers indicate that a pension plan can be

[1] Treas. Regs. 1.401–4(c).

made flexible by annually varying the salary and bonus. To do so is to invite attack on the reasonableness of the compensation.

A combination of plans may present a fair compromise between the older and younger men. Therefore, if a pension is in force, consider adding a profit-sharing plan rather than increasing benefits under the pension plan. In fact, there are many good reasons to have more than one plan. These advantages will be developed in the discussion of their integration with social security, investment policy, and insurance programs in the chapters which follow.

CHAPTER FIFTEEN

Investment Policy for the Plan; the Choice of Trustee

Some professional men recall the financial conditions of the 1930's all too vividly. For them, some of the stories of the era have more pathos than humor, and this memory still affects their investment policies. There is, for instance, the story of the Manhattan businessman of 1932 who staggered into his office and sank dejectedly into his chair.

"Imagine," he sighed, "I've got diabetes at 40."

"Well, what about me?" his companion retorted. "I'm stuck with General Motors at 7½!"

While those days are still painfully clear to some, every professional man can remember when he could borrow at 5½%, and 3½% municipal bonds were selling at par.

What will it be like at retirement? Will the safe, guaranteed-rate-of-return type of investment be the only thing which has kept its value, or will inflation

mean that the dollars returned have little relationship to the dollars invested?

This book does not pretend to offer investment advice. These points are made to show that an investment policy is a necessary but not easily defined objective.

All should agree that the investment policy will be limited to liquid securities. Real estate or unlisted securities provide little liquidity in the face of a sudden demand for cash to pay out vested interests or to pay tax deficiencies if this proves necessary.

All should agree that a reliable investment counselor will be entrusted to make all investment decisions.

There are determinable investment counseling fees built into these choices. Assuming the advice is worth the cost, one finds that the "bargain" cost to "do it yourself" may be the most expensive of all. The additional problem of any "do it yourself" project is that the professional men may become overly interested and concerned with the stock market, or overly critical of their associate or associates entrusted with the investment responsibility. There would appear to be no "bargain" approaches which avoid all costs. Performance, security, reliability, and peace of mind are not just words for casual consideration.

In any event, the investment policy will determine the trustee selected. The perpetual life of a corporate trustee is advantageous. However, one or a committee of professional men may be named trustee, with proper provisions for succession in the event of death or the inability of the individuals to continue. There is no tax problem if one or several of the covered professional men serve as trustees.

The investment policy for a money-purchase pension plan or for a profit-sharing plan can be more speculative than for a fixed-benefit pension plan. If the speculative investments of a money-purchase or profit-sharing plan

are successful, additional benefits will accrue to the individuals. If not, the individuals will ultimately receive less. However, since ultimate retirement benefits under a fixed-benefit pension plan are frequently looked upon as a form of "guarantee," the corporation may feel obliged to make up investment losses through additional contributions. This can be extremely painful.

CHAPTER SIXTEEN

The Role of Life Insurance

Life insurance has such unusual properties that it merits its special discussion.

To properly understand life insurance, the elements of protection and investment must be considered separately.

A. The Element of Protection

The stockholders should first consider a deductible group life coverage before considering insurance in a deferred benefit plan.

The main purpose of a professional corporation pension or profit-sharing plan is to provide retirement funds for the professional men. To the extent that needed pure insurance protection for the family can be provided by tax deductible corporate plans, such insurance protection is ordinarily not incompatible with

a plan to maximize retirement investments. This can be demonstrated if we understand that the needed protection for a professional man in the 50% tax bracket will require him to draw $2.00 taxable compensation from the corporation to pay $1.00 of life insurance premium. Relieved of the need to pay out that $2.00 of taxable compensation, the corporation will have an additional $2.00 to contribute to a pension or profit-sharing plan. After paying $1.00 for the insurance, the plan will still have an additional $1.00 available for investment toward retirement.

This illustration points up the fact that if additional insurance is needed by all the professional men, the payment of premiums by tax deductible dollars frees the tax savings for investment. The additional protection is needed if the group agrees that each is already under-insured and would continue the insurance even if the premiums became nondeductible by reason of withdrawal from the firm or by subsequent legislation or court action.

B. The Element of Investment

When the cost of protection, measured by the premium cost of pure term insurance, is deducted from the total insurance premium, the difference is investment. While this investment enjoys a reputation for security, the current increases in all interest rates make the return on the insurance investment compare unfavorably with secure bond investments now. This disparity may correct itself, or it may become worse.

In comparing insurance with other types of investment, the professional men will base their judgment on personal preference for either security or growth potential. However, insurance does possess certain other fea-

tures or attributes not associated with other types of investments, and these attributes must be understood when evaluating insurance as an investment.

Advantages of Life Insurance as an Investment

1. Security

Investment in insurance permits the participant of the plan to have protection in the case of his unexpected early death.

2. Waiver of Premium Available

A waiver of premium provision in an insurance policy will provide that if the employee is permanently disabled the insurance company will continue his life insurance without further payments. Without life insurance in the plan, disability benefits are difficult to provide.

3. Annuity Rates Guaranteed

If the professional men plan to choose a monthly lifetime income rather than periodic or lump sum at withdrawal, then insurance guarantees that the employee's account can be converted into a lifetime income based on annuity rates as of the date the policy was originally issued, even though annuity rates may have substantially increased in the interim.

4. Favorable Estate Tax Treatment

Again, assuming a member has a premature death, proper estate tax planning can assure favorable estate tax treatment on insurance proceeds.

5. Pension Plan Actuarial Costs Eliminated

If a pension plan is adopted, the actuarial costs could be a minimum of at least several hundred dollars per year. These actuarial costs will be performed by the insurance company at no cost. The savings is not a factor for money-purchase pension plans or profit-sharing plans. The insurance company will also help with administration of the plan.

6. Some Insurance for the Uninsurable

Insurance is ordinarily most attractive to the uninsurable. An insurance agent ordinarily can provide a reduced

amount of insurance, even for those who are otherwise uninsurable, in an employee benefit plan.

Disadvantages of Insurance as an Investment

1. Probability of Low Yields

If the decision is to stress growth as the investment policy, low insurance yields and no capital gains potential mean that ultimate retirement benefits should be less than could be produced by investments producing better yields. Even bond yield today often exceeds insurance. For those willing to assume risk, common stock offers dividend income and growth potential over the years. Still, the "low" yields of insurance may not seem low at all if the stock market were to plunge.

2. Forfeiture Benefits Reduced by Insurance

Since forfeitures can represent a substantial reduction in the net cost of a pension plan or additional benefits for remaining employees in a profit-sharing plan, any reduction of forfeitures is a major consideration. Forfeitures in an insured plan are less because insurance ordinarily is transferred to the terminating employee even if his length of employment has not been sufficient to vest his rights. In any event, cash surrender values are nominal in the first few years.

3. Inflexibility Can Prove a Straitjacket in Future Years

A commitment to insurance is the most obvious example of an inflexible investment program. Once undertaken, the need to continue premiums, even if there are no profits, can put financial pressure on the corporation. Furthermore, the need for insurance in family planning may lessen in future years when the children are grown, the home mortgage is paid off, and investment assets are accumulated.

C. Summary

If personally carried insurance coverage plus any new corporation group life coverage is not sufficient protection, the deductible employee benefit plan is an

excellent source of additional coverage. The professional men may, in fact, choose to take paid-up life coverage on present insurance to relieve their personal after-tax dollar drain. However, the inflexibility of a plan with insurance is a serious criticism. Once the plan is undertaken, the need to continue premiums, even if there are no profits, can put financial pressure on the corporation. Furthermore, the need for insurance in family planning may lessen in future years, as we have pointed out, when the children are grown, the home mortgage is paid off, and investment assets are accumulated.

This criticism can be obviated by proper planning. One of several possibilities is:

1. Limit insurance in the plan to the amount of protection needed by all. The balance of the contributions should be invested in securities through an auxiliary fund.
2. Plan the insurance carried personally so that curtailment can be effected in personal, after-tax cost insurance.
3. Establish two employee benefit plans. Put insurance in the pension plan, either fixed-benefit or money-purchase. Since these plans are relatively inflexible anyway, insurance is a more natural investment for such plans. Then establish a profit-sharing plan free of insurance. With a combination of these steps, a marked degree of flexibility can be achieved by varying contributions into the profit-sharing plan.

During this period of tax uncertainty when the entire concept of a professional service corporation is subject to attack and adverse legislation, professional service corporations should stress liquidity. The possibility that the venture will fail tax-wise should be considered in all planning. The professional men should not look to the insurance portion of the plan to pay any tax deficiencies that may ultimately arise.

CHAPTER SEVENTEEN

Advantages of Integration with Social Security

The phrase "integrated with social security" is not always clearly understood. Actually, all employees of a professional corporation are covered by a pension plan—the one provided by the Federal Insurance Contributions Act. If the employer establishes a plan that is "integrated with social security," the employer adopts a plan which considers social security part of the overall plan.

Because he had already contributed for a retirement plan through social security, the employer may desire to pay no benefits or lower benefits for wages below the social security tax base. This will either reduce the cost or permit increased benefits for higher paid employees. The employer will not have complete freedom in the execution of this desire. The tax law insists that the plan must not discriminate in favor of officers, shareholders, supervisors, or highly compensated employees.[1]

[1] IRC (1954) Section 401(a)(3)(B).

If the plan provisions comply with procedures set forth in the statute and the regulations, however, the plan is said to be integrated with social security and the resulting discrimination in favor of the higher paid employees is permitted. Simply stated, consideration may be given to the employer's participation in the social security program, and if the combined benefits that the employer provides under social security and the private plan are not more favorable for the higher paid individuals than the lower paid, then the plan will not be deemed to be discriminatory.

Authority for integration with social security is found in the Internal Revenue Code,[2] which reads:

A classification shall not be considered discriminatory . . . merely because it excludes employees the whole of whose remuneration constitutes "wages" under Section 3121(a) (1) (relating to the Federal Insurance Contributions Act) . . . Neither shall a plan be considered discriminatory . . . merely because the contributions or benefits based on that part of an employee's remuneration which is excluded from "wages" by Section 3121 (a) (1) differ from the contributions or benefits based on employee's remuneration not so excluded, or differ because of any retirement benefits created under state or federal law.

Integrated fixed-benefit pension plans have a number of restrictions which reduce contributions which otherwise may be made to the plan. Unfortunately for the older employee, there are provisions which limit otherwise permissible maximum contributions to an integrated fixed-benefit pension plan for his benefit. In the case of an employee with less than fifteen years of service with the employer at normal retirement age, his normal annual retirement benefit cannot exceed 2% of

[2] IRC (1954) Section 401(a)(5).

his average annual compensation in excess of the applicable integration level for each year of service.[3]

The maximum normal annual retirement benefits under a fixed-benefit pension plan may not exceed a straight life annuity of 30% of an employee's average annual compensation in excess of the applicable integration level.[4]

Both of the above percentage limitations are further reduced if the fixed-benefit plan provides death benefits, benefits other than a straight life annuity, or if the normal retirement age is lower than age 65 for men or age 60 for women.[5] The ruling spells out how these reductions will be computed.[6] Since most professional men will want death benefits and benefits other than a straight life annuity, the effective normal annual retirement benefit will be well under the 30% level of average annual compensation.

The maximum allowable contributions under a money-purchase pension plan or a profit-sharing plan is 6% of each employee's actual compensation in excess of $7,800.[7]

New regulations published in 1968 supersede the old regulations governing the integration of a pension plan with social security.[8] The new revenue rulings just published[9] represent the Treasury's final position on both pension and profit-sharing integrated plans, and replace the previous ruling[10] on integrated profit-sharing plans.

[3] Rev. Rul. 69–4 (Section 5.02–2).
[4] Rev. Rul. 69–4 (Section 5.02–1).
[5] Rev. Rul. 69–4 (Section 4).
[6] Rev. Rul. 69–4 (Sections 8 through 11).
[7] Rev. Rul. 69–4 (Sections 13 and 14; see also Section 20.04, example 6).
[8] Treas. Regs. 1.401–3(e)(2).
[9] Rev. Rul. 69–4 and 69–5.
[10] Rev. Rul. 61–75.

Anyone considering an integrated plan should carefully study the restrictions placed on such plans, not only the maximum contributions permitted, but also certain restrictions on other benefits or features of such plans.

The previous chapter discussed the advantages of providing life insurance coverage in a pension plan rather than in a profit-sharing plan. Forfeitures will be less in plans with life insurance programs. This may not disturb the professional men, however, if the participants are the key employees. In fact, this desire to compensate key personnel currently may cause professional men to shorten the time required for full vesting of an integrated plan.

The solution may be an insurance funded pension plan (fixed-benefit or money-purchase) integrated with social security and combined with a flexible profit-sharing plan.

Because the stockholders receive a greater proportionate benefit from an integrated plan, integrated plans ordinarily are designed to maximize the amount of permitted contributions. However, the Tax Reform Act of 1969 may cause cautious planners to change this approach of maximizing permitted contributions to the integrated plan. The Act will effectively limit contributions by a Subchapter S corporation to the lesser of 10% of compensation or $2,500 for any stockholder-employee. If at some later year the professional corporation is driven by Internal Revenue Service attacks to make a Subchapter S election, it may prefer that the integrated pension plan does not provide benefits in excess of what would then be deductible by a Subchapter S corporation. If a second employee benefit plan is also in force, it can be frozen or contributions to it can be drastically curtailed.

Integrated plans will not appeal to every group. Many groups will prefer to cover all employees. Inte-

gration will be most effective where the ratio of non-stockholder-employees to stockholder-employees is the greatest. It will have little impact if the ratio is very low.

CHAPTER EIGHTEEN

Should the Plan Be Conditional on Approval by the Internal Revenue Service?

The recent Treasury recognition of the professional corporation, based on court defeats of the Commissioner's 1965 Regulations, has not provided full assurance that all professional corporations in all states will be recognized. Until this uncertainty is resolved, professional corporations must continue to beware of the wording of this conditional clause in any pension or profit-sharing plan.

An Internal Revenue Service ruling sets forth the conditions under which a conditional clause in a pension or profit-sharing plan will be permitted.[1] The ruling reads:

Conditional Payments—A provision in a newly established plan for the return of employer contributions only in the event that the Commissioner of Internal Revenue rules that the plan is not qualified does not, of itself, prevent qualification of a plan and exemption of a trust. The plan must be in

[1] Rev. Rul. 65–178.

full force and effect and the non-reversionary provisions must otherwise prevent the non-exempt use of the funds. It is only where the Commissioner's determination that the plan does not qualify that a recovery of employer contributions made prior to such determination is possible. Under such circumstances, the conditional payment, and the provision, therefore, are held not to prevent qualification of the plan and exemption of the trust. See Rev. Rul. 60–276, 1960–2, C.B. 150.

These questions are raised:

1. Is the "determination" referred to above the decision of the Commissioner, or does the "determination" continue until final solution has been reached by a court decision?
2. If a conditional clause is included in the plan, will a possible unfavorable original determination by the district director automatically terminate the plan and, as such, defeat any pursuit that the company could hope to obtain through court action? Alternatively, in the event that no such conditional provision is included in the plan, would a subsequent defeat of a professional corporation status in the courts mean then that, upon the termination of the plan (the professional men no longer desiring to continue a nondeductible plan), all rights of nonprofessional employees would automatically vest? Would this mean their share would be paid to them on the termination of the plan, but the professional men would receive no tax deduction for the amounts set aside for those employees?

These questions were posed to a well-known and highly respected tax law firm. The managing partner of that firm answered as follows:

To answer the first question: The Service—right or wrong —approves only clauses that turn on the Commissioner's *decision about the initial qualification of a new plan, not,*

for example, on a final court determination in a disputed case. If Rev. Rul. 65-178, 1965-2 C.B. 94, and Rev. Rul. 60-276, 1960-2 C.B. 150, leave any doubt about this, there is no doubt at the national office. They advised me yesterday that only the Commissioner's action would be included and not a court decision.

This attorney went on to state that in his opinion an acceptable clause would not require termination after an unfavorable determination by the district director. He stated that its operation may await a final unfavorable ruling by the national office. He added that, in most cases, the district director would await a national office decision before issuing his letter.

As to the second question, he replied:

In a professional corporation case involving probable Internal Revenue Service disapproval, the foregoing creates a problem. In the absence of a condition, rights of employees would be vested if the employer decided to terminate the plan. Repayment to the employer would not be permitted. Moreover, the Service position is that if rights of the employees in a nonqualified plan are forfeitable in the year of contribution, the employer loses his deduction. On the latter point, however, the Court of Claims and Second Circuit disagree with the Commissioner, holding that if in the year of payment to the employee his rights have become nonforfeitable, the contribution is deductible in the year of payment. Buttrey Stores, Inc. vs. U.S. 67-1, USTC 9 361, 375 F. 2d 799 (ct. Cl. 1967); U.S. vs. Russell Mfg. Co., 65-2 USTC 9541, 749 F. 2d. 13, 19 (2d Cir. 1965). This holding reduces your exposure to some extent.

To conclude, there should be either no conditional clause or a wording for a conditional clause requiring affirmative action on the part of the corporation to trigger termination in the event of Internal Revenue Service disapproval of the plan, rather than the automatic

termination ordinarily provided in most plans. The same tax attorney suggested the following revised wording for inclusion in any plan:

Plan conditional on approval by Commissioner of Internal Revenue:
The adoption of this plan is conditional on receipt of a determination by the Commissioner of Internal Revenue that the plan and the trust are qualified initially *under Section 401 (a) of the Internal Revenue Code or any amendment thereof. Unless and until such determination is made and communicated to the employer, no employee, beneficiary, participant or any other person shall have any right under the plan or against the trust fund and trustee, the employer, any insuror or any other person. If the Commissioner of Internal Revenue shall issue a final determination that the plan and the trust are not qualified* initially, *this plan shall,* upon affirmative action taken by the company within sixty (60) days, *terminate and the trustees shall refund and redeliver to the company to be dealt with by the company as its own property, all property included in the trust fund and upon termination of such refund and redelivery, the trustee and the company shall be discharged from any further responsibility hereunder and no employee, participant, beneficiary, or other person shall have any rights under the plan.*

The key wording above is underlined. What this wording does is give the taxpayer the right to take another look at the situation at a later date, if the Commissioner has disallowed the plan, to see, in light of the latest court cases until that time, whether or not the risk of continuing is warranted. The taxpayer can either "cash in his chips" with practically no disadvantage to himself for having tried or, on the other hand, he can go on and test the Commissioner's position knowing that he then runs the risk of vesting the contributions set aside for his employees in the event the plan ultimately fails.

This is a clause which buys some time and does not commit the professional men to any one course of action at the time the plan is introduced. Guard against any wording which would automatically terminate the plan in the event the Commissioner determines that the plan does not qualify.

Since the first draft of this book, some light has been thrown on the subject by the Wallace *et al.* v. U.S., a District Court of Arkansas case. In the Wallace case, the Treasury raised the argument that the profit-sharing plan of the Professional Corporation, formed pursuant to the Arkansas Medical Corporation Act, was not qualified because it contained the following clause (Section 19 of the Wallace Plan):

The contributions by the Company to the trust pursuant to this Plan shall be irrevocable, subject, however, to the approval of the Plan in its original form, or as amended, by the Internal Revenue Service and the allowance of a deduction for all of said contributions by reason thereof. In the event the Plan is not approved by the Internal Revenue Service, all contributions and accumulated income shall be returned to the Company and the rights of all participants shall be deemed forfeited.

In addition, the court considered whether or not the plan had terminated when the Internal Revenue Service disapproved the plan. The decision was complicated by the fact that the plan was in effect for the years 1963 and 1964—years not challenged by the Internal Revenue Service. Furthermore, it appears that the government stipulated its case away by agreeing that the recapture provision of the quoted Section 19 should be limited to contributions for the year ended 6-30-65, that the deductions for fiscal years ended 6-30-63 and 6-30-64 were unchallenged, and finally, that the parties to the plan considered the allowance of the deductions to be

tantamount to an approval of the plan as qualifying under Section 401(a)(2). As a result, the court concluded:

In view of those stipulations it seems clear to the Court that the Association and its employees anticipated that the plan would be considered by the Internal Revenue Service in connection with the 1963 tax returns, and that the plan would either be approved immediately, perhaps after amendment, or that it would be rejected immediately in which event the year's contributions would be returned to the Association and the plan would be terminated. Whether or not they were justified in considering that the failure of the Internal Revenue Service to challenge the deductions amounted to an approval of the plan, the Court thinks that such participation and consideration were not unreasonable.

One cannot gain a great deal of comfort from this court decision, even though it favored the taxpayer. Remember that the government will not be faced with the years prior to 1965 in any new plan formed now. Those years which they have agreed to approve proved embarrassing to the government's case. Today, if the government disapproves of a plan initially, the plan which provides for automatic termination in the event of initial disapproval may be attacked. This really is all that has been learned from the Wallace decision—that the government is very much aware of this pitfall.

CHAPTER NINETEEN

Other Key Features of the Plan Which Must Be Considered

A. Deferred Vesting

Should the plan provide for deferred vesting? If so, for how long?

There are two main advantages in deferring vesting as long as possible:

1. The employees, particularly the key professional men, will be discouraged from leaving the organization if they forfeit certain nonvested rights under the plan. This builds cohesiveness in the organization and is of extreme value.
2. Those who remain will benefit from the forfeitures of those who do leave the organization.

Under any plan, full vesting should be automatic in the event of retirement, death, or disability. Thus, vesting becomes a factor only in the event of termination

of employment other than by retirement, death, or disability. The professional man must realize that, although he is one of those forming the corporation, he too would be subject to a loss of nonvested rights should his plans change and he decide to leave the organization. The advantages of deferred vesting outweigh, in almost every instance, the disadvantages. However, because the professional corporation will be subject to critical scrutiny, vesting should be completed within a reasonable time so that the Internal Revenue Service cannot challenge the validity of the plan.

Profit-sharing plans have been approved with no vesting for the first two years, and 20% after two years, with another 10% vesting for each year until full vesting is reached after ten years. Pension plans have been approved with no vesting for five years and 10% vesting for each year until full vesting is reached after fifteen years. The Treasury constantly seeks to lower the period required for vesting.

B. Forfeitures

Because of deferred vesting provisions, an employee who terminates employment may forfeit a portion of his credited account in the employee benefit plan. Forfeitures in pension plans will be applied to reduce future employer contributions.

Profit-sharing plans ordinarily will provide that forfeitures shall be allocated to participants in the same manner as employer contributions. In Rev. Rul. 68-302, the Commissioner holds that if forfeitures which result because of a lack of vesting inure principally to the benefit of the "officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees," the plan

will not qualify. Accordingly, the safest course in lieu of rapid vesting may be to provide that forfeitures in profit-sharing plans shall be applied to reduce future employer contributions.

C. Voluntary Contributions and Withdrawals

Should the plan permit participating employees to contribute voluntarily to the plan, and should they be able to subsequently withdraw voluntary contributions from the plan?

Such provisions would not ordinarily be a part of a professional corporation pension plan, but are a valuable addition to a profit-sharing plan. Not every professional man, because of personal financial responsibilities, can set aside the same amount of money. In most instances, the corporate contribution will be based on the needs of that professional man who can spare the least sum for investments. The other employees, if such a voluntary contribution provision exists, can contribute voluntarily into the plan and the income and capital gains accruing will compound for them tax-free within the plan. The Treasury has ruled that voluntary contributions of 10% of compensation are within reasonable bounds.[1]

Plans permitting voluntary contributions ordinarily permit the participant to withdraw his contribution. Because the status of company contributions and voluntary contributions do differ, separate account balances for the employee must be maintained. Income earned

[1] Rev. Rul. 65–178, Part 4(g) and (h); Rev. Rul. 59–185, 1959–1 C.B. 86; Rev. Rul. 69–217 IRB 1968–18, page 8.

on employee contributions will be calculated separately and added separately to that contribution account.

D. Borrowing from the Plan

Should the plan permit participating employees to borrow from the plan?

Tax Management Portfolio No. 165, entitled "Pension Plans—Qualification," comments:

A provision for loans from a pension plan may raise questions about the true nature of the plan and is relatively uncommon. Loan privileges are usually associated with profit-sharing plans.

Provision may be made for the granting of loans to participants up to the extent of their vested interests subject to the application of specified uniform rules consistently followed. It should be noted, however, that so-called "loans" may constitute "distributions" if there is tacit understanding between the parties that collection is not intended.[2]

Most advisers are of the opinion that any permission for loans to participants should require interest and security consistent with requirements for transactions with prohibited persons.[3] Inadequate interest rates or security will invite an examining agent to argue that this policy either discriminates in practice, or that the transaction represents a distribution, taxable as ordinary income.

Borrowing would seem somehow to defeat the pur-

[2] Quoted from Rev. Rul. 65–178, Part 5(o).
[3] Treas. Regs. 1.503(c)–1 and Rev. Proc. 67–4.

pose of the plan, for the plan is intended to set aside money to be available upon retirement. However, keep in mind that in the short-run period, the plan should provide liquidity in the event it becomes necessary for the professional men to pay a proposed tax deficiency and sue for refund.

E. Waiting Period and Minimum Age

Should there be a waiting period and a minimum age for eligibility?

Since the professional corporation will be a new entity, care should be taken that the terms of the waiting period do not prevent everyone from being eligible for a period of time. If vesting is deferred as long as possible, it would appear that there is not much advantage in a waiting period, and a waiting period may make it more difficult for the members to attract a young professional man into the organization.

The minimum age for eligibility should apply to all personnel, if used at all. A minimum age of twenty-five is usually preferred. If a waiting period is used, the waiting period should probably not be more than a two-year period or new employees may become discouraged. Participation could begin as of the next anniversary date of the plan after one's employment.

Notwithstanding the fact that the Internal Revenue Service approves many plans containing waiting periods and a minimum age restriction, they may still rule later that the plan "discriminates in practice," and, therefore, is not qualified, if the plan clearly separates professional from clerical employees. Continue to be cautious in these areas.

F. Definition of Compensation

How will compensation be defined? Will it be base pay or will it be base pay plus bonuses and overtime?

In a fixed-benefit pension plan, professional corporations must be very careful not to permit the compensation subject to the plan to fluctuate greatly since benefits under the plan (and thus the cost) are related to compensation. For instance, there are documented cases in which the professional corporation raised the total compensation subject to the plan almost 50% in the few years prior to a retirement. In that case, the corporation's liability under the plan increased to a staggering figure because the benefits under the plan increased 50% and these benefits necessarily had to be funded in the short period of time prior to retirement. Preferably, compensation should be considered the base pay only, and any increase in base pay should be made only after a careful consideration, by all of the participants, of the effect that the increase will have upon the retirement benefits to each professional man and to the cost of the increase. If the corporation is a Subchapter S corporation, the earnings over the base compensation can be easily paid out to each participant, so there would be no fear that failure to raise base compensation would "lock up" funds in the corporation.

If the plan is a profit-sharing plan, the problem is not so critical. The biggest problem in that case is the question of whether or not compensation is excessive. If the Internal Revenue Service were to argue successfully that the total of base compensation plus bonuses was excessive, then a portion of the compensation and a related portion of the contribution into the profit-sharing

plan would be affected. This whole risk is particularly unnecessary if the corporation does not plan to contribute the full 15% in any event. On the other hand, if the corporation could contribute more than 15% of base compensation, then the corporation should consider either raising the base compensation or adding a pension plan to the already existing profit-sharing plan. Base pay should be computed carefully. This computation should start with the total earnings of each professional man during the operation of the partnership. From these total earnings should be subtracted the maximum amount he could expect to contribute under the plan, and an additional amount which would represent a margin for error. Then one should determine if such a salary could be considered excessive. While this calculated base pay is subject to adjustment during the years, the adjustment should not be done arbitrarily and should only be done after careful consideration as to the impact that it will have on the tax picture of the company.

G. Valuing of Assets

How often should the assets of the plan be valued?

Most plans provide for an annual valuation of assets in the plan. For a sizable commercial organization this is probably the only practical method, for repeated valuations would be most tedious. However, one annual valuation does present the possibility for inequities. This is so because withdrawals from the plan are always permitted—certainly for retirement, death, disability, and termination of employment—and some plans even provide that the employee may withdraw contributions,

either vested company contributions or employee voluntary contributions. If the withdrawal is based on valuations at the beginning of the year, a withdrawal by an employee during the year, after a severe stock market decline, could permit the employee to withdraw far more than the current market value of his established equity in the plan. Because of the small number of employees in the average professional corporation, a provision for the valuation of the assets of the plan at the time of any withdrawal, as well as annually, would not be a hardship, and it would prohibit an employee from taking advantage of the situation. The reverse of this would also be true—valuation at withdrawal would mean that the employee would benefit from any increase in market valuations subsequent to the first of the year.

H. Effect of Withdrawals on Earnings

What effect do withdrawals of employee contributions during the year have on the allocation of earnings of the plan during the year?

Many plans provide that the annual earnings of the plan (not forfeitures or employer contributions) shall be allocated to the participants based on the first-of-the-year revised valuations of each employee's share in the plan. If this is the case, any voluntary contribution by the employee during the year would earn no credit for its share of income of the plan during that year of contribution. This is not too much of a problem since it is a voluntary transaction and the employee could cover himself by making all contributions late in the year. For this reason, lump-sum contributions should be permitted as well as payroll deductions.

The effect of withdrawals is more serious. The terms of the plan may be such as to permit an employee to withdraw from the plan during the year and not affect the credit which he would receive on the allocation of current year income of the plan. Thus, funds withdrawn in the first month of the new year would have contributed almost nothing to the earnings of the plan during the year, and yet the employee would receive a full year's share of income. Since withdrawals are also voluntary, consider a formula designed to subtract any withdrawals from the first-of-the-year balance for purposes of computing allocation of income for the year unless the withdrawal is late in the year (for instance, in the last one or two months of the plan year).

I. Percentage of Compensation Which Corporation Contributes

Should a profit-sharing plan set the percent of compensation which the corporation shall contribute or should it be silent on the subject?

Most profit-sharing plan advisers suggest that a percent of compensation be stated in the plan; the company is permitted to alter the percent of contribution up or down at its discretion. Fixing the liability would be of some advantage to an accrual basis taxpayer who might otherwise have forgotten to vote a specific percentage prior to the end of the fiscal year. A cash-basis professional corporation would have little use for such a provision and it would appear best to just permit the company to make contributions at its discretion, up to the maximum allowed as a deduction for income tax purposes.

Again, this would not affect a pension plan as the company's liability is not limited to a percent of compensation, but rather is that sum which is required by an actuarial calculation to provide for benefits under the plan.

Most plans are drawn for accrual basis taxpayers so the usual format is to require payment within two and a half months following the close of the fiscal year. Remember that professional corporations will undoubtedly be on the cash basis, so the plan should provide for payments prior to the end of the year, not afterward.

J. Earmarking

Should the plan permit earmarking?

A profit-sharing or money-purchase pension plan can be designed to permit each participant to determine the amount (up to 50%) of the contribution which shall be invested in insurance. It may permit earmarking of individual accounts so that each participant can develop an individual investment program for that portion of the contribution by the corporation which was made for his benefit, and is not used for insurance. Where professional men are divided on the need for insurance, or the type of security investments preferred, individual preferences may be satisfied by earmarking each participant's account.

Realize however that this individual preference type plan is more difficult to administer. Furthermore, qualified investment counseling may be difficult to obtain because of the number of small accounts resulting. As an alternative, the plan can be designed to permit each participant to choose the amount, if any, of insurance

coverage he desires, and the balance of the contribution for his benefit can then be credited to his account in the common trust fund for all participants. This will then give freedom of selection regarding insurance but permit no flexibility in the investment program. This compromise will make administration and investment less complex.

Earmarking can be a useful factor after one's retirement. Even if a common fund is used during employment, the retired employee may prefer to leave the funds credited to his account in the plan and withdraw them periodically over a period of time less than his life expectancy. This may be a much more preferable election than either a lump-sum withdrawal or the purchase of an annuity contract. Annuity contracts are safe, but the net yields are very low. Conversely, the immediate tax drain caused by a lump-sum withdrawal reduces at once the earning power of the assets in the fund.

The Tax Reform Act of 1969 makes the lump-sum withdrawal even less attractive by taxing as ordinary income that portion of the distribution representing contributions into the plan by the employer after January 1, 1970.

Therefore any plan should consider incorporating this feature as well as the usual retirement elections of lump sum or annuity.

K. Qualifying the Plan with the Internal Revenue Service

Should the corporation attempt to qualify the plan with the Internal Revenue Service?

The Treasury position toward any attempt to qualify a professional service corporation's pension or profit-

sharing plan has shifted from time to time and possibly is not uniform nationwide even now. District offices are still awaiting instructions from the Commissioner regarding plans submitted or to be submitted for approval.

When the Treasury reviews all applications now held in suspense, a number of the plans will undoubtedly require amendment for various reasons. In an informal communication the Internal Revenue Service has stated that if the professional corporation then promptly amends the plan to cure exceptions raised by the Internal Revenue Service, there will be no administrative determination that contributions to the plan should be disallowed in the years prior to the time the favorable determination letter is finally issued.

The Internal Revenue Service would not reveal, however, its position in the event the corporation had not requested a determination and, upon subsequent examination, the Treasury determined that the plan did not qualify as it was written. Curing the deficiencies at that point could leave in jeopardy those contributions to the plan made prior to its amendment.

With this information, should the corporation submit a determination request? There are advisers who recommend against such action. They feel it is a useless expense since the Treasury is now holding such requests in suspense. They further argue that it would be time enough to amend the plan when, and if, it is ever examined and criticized by the Internal Revenue Service.

What can be gained by not submitting a request? The cost of preparing and submitting the request.

What can be lost? The deduction for all contributions into the plan in the years prior to action taken by the corporation to cure objections to the plan raised in an Internal Revenue Service examination.

In light of the Treasury's conception of all professional service corporations as tax-saving technical loopholes, it

is certainly reasonable to expect the Internal Revenue Service to respond with technicalities to defeat the tax savings. Since the Internal Revenue Service can argue that administrative procedures do exist to obtain a status determination, any attempt to circumvent the procedures should be looked on as an invitation to litigation. Because such litigation is certain to be not only expensive but risky, the professional corporation should submit a request for determination even if it is expected that the request will be held in suspense.

The taxpayer cannot be certain that the verbal opinion we received will reflect the final Treasury position. Still, exposure is reduced by a timely application. The risk involved by not filing does not justify the cost savings produced by refusal to file.

This same recommendation is equally valid if the Internal Revenue Service rules unfavorably on any request or continues to hold all applications in suspense.

PART FOUR

Other Corporate Fringe Benefits

CHAPTER TWENTY

Other Fringe Benefits Made Available by Professional Corporations

In addition to the tax advantages of qualified corporate pension and profit-sharing plans, other corporate fringe benefits can provide further tax advantages. As is the case with qualified pension and profit-sharing plans, the benefits derived from the plan discussed in this chapter are available to all corporations and are not unique to professional corporations. The intent here is not to present a detailed discussion of the tax aspects of these plans, but merely, for purposes of completeness, to summarize briefly the advantages and disadvantages of these fringe benefits.

A. Medical Benefit Plans

These plans provide three general categories of benefits:

1. Reimbursement for medical expenses.
2. Payment to compensate for a permanent injury or disfigurement.
3. Payment during absence from work because of personal injury, sickness, or other disability.

Section 106 of the Internal Revenue Code of 1954 provides that the employee is not taxed because of contributions by his employer to a plan which provides medical benefits.

All medical benefit plans should be authorized as *employee* benefits contractually or in corporate minutes and should be reviewed periodically by the board of directors. These plans need not cover all employees. They can be reserved to a class of employees. However, if they are restricted to only stockholder-employees, the Internal Revenue Service may take the position that they are provided to the stockholders as stockholders and not as employees.[1] The Internal Revenue Service would then tax payments under the plan as dividends to the stockholders. It is important, therefore, that the payment is made on behalf of the professional man because of his status as an employee and not because he is a stockholder.[2] A plan that provides benefits for at least some employees who are not also shareholders will be less subject to attack than one exclusively for stockholder-employees.

1. Medical Expense Reimbursement Plans

The corporation may incorporate in the minutes or other official documents a plan to reimburse directly the professional men and other covered employees and their dependents for medical expenses incurred. Rather than direct reimbursement, the corporation may prefer to purchase

[1] Larkin v. Comm., CA–1 (1968), 394 F. 2d 494.
[2] Bogene, Inc., T.C. Memo 1968–147; Edward Smithback, T.C. Memo 1969–136.

health, dental, accident, and major medical or other medical benefit insurance for the professional men, other employees, and their dependents. This insurance can be either group or individual policies. Section 105(b) of the Internal Revenue Code provides generally that the employee is not taxable on receipt of these benefits (either from an insurance company or directly from the employer) if they are to reimburse the employee for expenses incurred by the employee for the medical care of himself, his spouse, or his dependents. The payments are taxable, however, to the extent that a medical expense deduction has been allowed on the employee's personal tax return. Most high bracket professional men would obtain only limited, if any, benefit from a medical expense deduction on their personal return. Providing the benefits through deductible corporate payments under a plan almost always offers a major tax advantage.

The professional man must take into consideration the additional cost to cover employees. Although this may offset wholly or in part the tax savings to the professional men, it is important to measure the effect of these and other fringe benefits on the morale of employees.

The regulations, Section 1.105-5, state that there may be different plans for different employees or classes of employees, apparently implying a medical expense reimbursement may be made on a discriminatory basis among employees. It must also be considered that payments made under these medical reimbursement plans are considered along with direct compensation and other types of fringe benefits in determining reasonableness of compensation.

2. Payment for Permanent Injury

Section 105(c) of the Internal Revenue Code provides that an employee is not taxed on any amount which he receives as payment for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement of himself, his spouse, or a dependent if the payments are computed with reference to the nature of the injury without regard to the period the employee is absent from work. This is true whether the payment is received

through direct payment from the corporation or from employer-provided insurance.

Disability insurance should be provided for in the employment contract.

3. Compensation during Absence from Work

Payments to an employee during absence from work pursuant to a plan (often referred to as wage continuation or sick-pay plans) may be excluded from the employee's income only to the extent that they meet the requirement of Internal Revenue Code Section 105(d). For the first thirty days of absence from work, the tax exempt amount cannot exceed $75 a week. For absences extending beyond thirty days, sick pay is tax exempt up to $100 each week beyond the thirty days. The rules are the same whether the sick pay is paid directly by the employer or by an insurance company from a contract provided by employer contribution. Since disability insurance is no longer deductible as a medical expense by an individual, it is an ideal benefit in a corporate plan for professional men. Key men may be covered without covering all employees. Again, however, care must be taken that the plan is for employees, not stockholders. Therefore, consider providing disability insurance for all employees so that any continuing insurance payment received by a professional man who may become disabled will be subject to this tax advantage.

B. Group Life Insurance

The premiums for ordinary life insurance (not part of a group plan) for which the employee can name the beneficiary are deductible as additional compensation by the employer, but they are also taxable to the employee. Where life insurance is purchased and the corporation is the beneficiary, nothing is taxable to the employee, but the premiums are not deductible by the corporation. Group term life insurance, however, pro-

vides special tax benefits. The employee is not taxed on any premiums paid by his employer for group term insurance up to $50,000 coverage. The employer may deduct the insurance premium as a business expense. If the employee is furnished life insurance protection in excess of $50,000, he will be taxed on the "cost" of the insurance coverage in excess of $50,000 for the taxable year reduced by any amount the individual pays himself for that year's coverage. The "cost" of insurance for this purpose is figured by using a Treasury table of insurance costs. Generally, the "costs" are substantially below the actual group term insurance costs being incurred today. Therefore, even insurance in excess of $50,000 can be provided with the only cost to the employee being the tax on the theoretical "cost."

The employee might also escape the estate tax on the insurance proceeds on his death if he can effectively transfer the incidence of ownership of that insurance to his wife or someone else. In this respect, the provisions of Revenue Ruling 68-334, IRB 1968-26, page 19, and Revenue Ruling 69-54, IRB 1969-6, page 20, and the case of Lillian Landorf, Executrix v, U.S. (*Ct. Cl.* 3/14/69) should be consulted.

C. Death Benefits for Widow and Children

In addition to furnishing life insurance, the corporation can pay tax-favored death benefits to a deceased professional man's widow, children, or estate.[3] The benefits would be deductible by the company as compensation and would be tax-free to the recipients up to $5,000. There is no exclusion for amounts in excess of $5,000, no matter how many beneficiaries the payments

[3] IRC (1954) Section 101(b).

are made to. Where payments are made to more than one beneficiary, they must divide the $5,000 exclusion between them.

D. Estate Tax Benefits

Amounts payable under a qualified corporate pension or profit-sharing plan to the extent provided by corporate contributions will pass estate tax-free if the proceeds are payable to a designated beneficiary other than the estate or legal representative of the decedent.[4] Furthermore, it is good estate planning to provide that the amounts payable under a qualified pension or profit-sharing plan shall not be paid to the spouse but, rather, paid to a trust for the lifetime benefit of the spouse. In this way, the proceeds will also pass free of the estate tax on the spouse's estate. Therefore, all participants in a corporate pension or profit-sharing plan are advised to review their wills and undertake estate planning to take advantage of this possibility.

E. Other Benefits

Other benefits that are often provided include expense accounts, continuing professional education and training, club memberships, and use of company automobiles.

Unlike pension and profit-sharing plans, many of these benefits are available to a limited group of employees without restriction as to nondiscrimination. However, the professional corporation must be careful that the plans provide benefits to the professional men as employees and not as stockholders.

[4] IRC (1954) Section 2039(c).

F. Lower Corporate Tax Rates on Retained Earnings

The corporate brackets for the first $25,000 annual taxable income will be much less than personal tax brackets. If the corporation does not elect the Subchapter S tax treatment, any profits retained in the business will receive this favorable tax treatment.

APPENDIX

Professional Corporation Data Sheets

Schedule A: Pre-Incorporation Planning
Schedule B: Fringe Benefit Plans
Schedule C: Pension and Profit-Sharing Plans
Schedule D: Post-Incorporation Follow-up
Schedule E: Annual Review

Important: Data sheets A through C are not feasibility studies. They should be used only after determination has already been made to organize as a professional corporation. That decision should be made only after the professional men understand the advantages and disadvantages inherent in operating as a professional corporation, and vote to go forward.

Advantages of a Professional Service Corporation

1. Ability for professional men to receive a tax deduction while investing earnings that will grow and compound income-tax-free while the plan continues—a way to financial independence

2. Deductible group life (small groups may not qualify)
3. Deductible disability insurance
4. Deductible medical insurance
5. Professional men can accumulate retained earnings while remaining in a low corporate tax bracket
6. Limited liability
7. Continuity
8. Transferability of interest
9. Corporate practice is forced to be more distinctly organized, encourages efficiency and continuity
10. Corporation is a more attractive package to recruit young professional men

Disadvantages of a Professional Service Corporation

1. The participants must be able to currently part with a spendable, after-tax dollar to invest approximately two dollars. If some cannot, the tax advantages vanish.
2. The professional men *must* operate as a corporation and must be, in fact, employees, keep minutes, conduct any business matters as a corporation, operate a pension or profit-sharing plan properly, etc. If there is any feeling that a corporate practice in

any way intrudes on the ethics of the profession, or that the extra time devoted to business problems will conflict with professional duties, consider postponing action.

3. There are still possible avenues of attack open to the Internal Revenue Service. These should be understood.
4. The state law may be inadequate or the governing professional society may be opposed to corporate practice.
5. Status as a corporate employee may be a disadvantage when one is serving some clients.
6. Contributions by the employer to, and earnings in, a pension or profit-sharing plan will be taxed when withdrawn.
7. The increased costs of these benefits, less tax thereon, paid for the nonprofessional employees serves to reduce the money set aside for the professional men themselves. Will there be any tangible benefit of employee satisfaction reflected in reduced turnover or better recruiting?
8. There will be increased costs, both originally to form and later to maintain the program. These costs may be greater than expected. Furthermore, the professional men's salary will be subjected to payroll taxes and workmen's compensation insurance. There will be state franchise fees.

Summary

Client: _____

Advantages and disadvantages of professional corporations have been explained to the professional men by _____

on (Date) _____

Their decision was to:

Go ahead without delay _____

Need time to consider _____

Postpone consideration at this time _____

Problem areas are _____

_____

We are asked to help resolve problem areas by _____

_____

Fee quoted _____

For the following services _____

_____

We are to work with _____

_____

Expected time to complete _____

SCHEDULE A

Pre-Incorporation Planning (Early stage information and decisions)

Note: If the state law provides for associations rather than corporations, material differences in the plan can result. The areas here relating to the charter, stock, stock redemption, ability to hold title to real estate, assume indebtedness, etc., will necessitate inclusion of supporting schedules explaining problems and solutions based on local conditions from state to state.

State law permits corporations/associations _____
Copy of statute attached? _____
Proposed corporate name _____
Fictitious name permitted? _____ Desired? _____
Fictitious name selected _____
Main office mailing address _____
Shareholder, etc., information (if more than six, attach supplementary schedule)

Shareholder Name	Social Security Number	Number of Shares	Director? (Y or N)	Officer? (Title)

Total shares authorized _____ Number issued _____ Par _____ _____

Corporation the successor to: _____
_____
Type of profession practiced _____

Attitude of governing professional society _____
State of incorporation _____
The state law: Is it adequate? _____
Corporation's resident agent to be _____

Names of Professional Advisers and Suppliers

	Phone no.
Attorney	
CPA	
Actuary (if needed)	
Employee Plan Specialist	
Bank	
Printer	
Stockholder who will represent group	

Preferred Insurance Agent

	Phone no.
Life insurance	
General insurance	

Malpractice insurance _____ _____
Medical & major medical _____ _____
Disability insurance _____ _____

Information for Stock Redemption Agreement (or buy-sell, if necessary)

Redemption price formula _____
(Important—We recommend book value, ignoring receivables and goodwill.)
First refusal terms _____
Time allowed to exercise, date of first payment, interest rate, etc. _____
_____
Any conditions in state law requiring redemption _____
_____
Conditions under which stock will be redeemed _____
_____
Will restriction be inscribed on certificates? _____
_____
Desire a separate memo of understanding explaining redemption price formula?
_____

	Name	Annual salary		Name	Annual salary
1.			4.		
2.			5.		
3.			6.		

Pay period (weekly, bi-weekly, semi-monthly, monthly) _____

Date of first pay period: From _____ to _____

Contract to terminate on _____

Method of paying or reimbursing promotion and entertainment expenses established and explained? Describe and comment: _____

_____

_____

_____

Method of paying auto, professional dues, seminar, etc., expenses established and explained? Describe and comment: _____

_____

_____

_____

Outside activities restricted? _____ Require solvency? _____

Require good standing in profession? _____ Hospital staff privileges (for doctors)? _____

Require certain professional attainment (becoming a diplomate, etc.)? _____
Require he be insurable for malpractice? _____ Moral character? _____
Agreed vacation terms _____
Agreed time off for professional meetings, etc. _____
Any provision for pay reduction for unauthorized time off _____
_____
Terms of voluntary termination—notice terms _____
Terms of involuntary termination—notice terms _____
Any prohibition against assignment _____
Any non-compete agreement desired _____
Will repay salary or expenses disallowed by Internal Revenue Service? _____
(See Vincent Oswald, 49 T.C. 645; acq. IRB 1968-45,5)

Proposed Termination Pay Benefits

Name	Upon retirement	Upon death[1]	Upon disability[2]	Upon withdrawal

Any future new man	_____	_____	_____	_____
Date payments are to begin	_____	_____	_____	_____
Number of payments	_____	_____	_____	_____
Pay periods (monthly, quarterly)	_____	_____	_____	_____

[1] If there is life insurance in any pension or profit-sharing plan and if the corporation adopts a group life insurance plan, there may be little or no need for death benefits.
[2] Terms here will dovetail into provisions of any disability insurance coverage which may begin anywhere from 30 to 180 days from disability.

Charter and Bylaws—Documents

Will the agreement to incorporate recite business purpose of incorporation? _____
Which is _____
Agreement to incorporate to cover treatment of receivables and payables? _____
Which is _____
Bylaws provide for reimbursement of disallowed salary and expenses? _____
Initial minutes to elect to issue Sec. 1244 stock? _____
Charter to be filed by (date) _____
Proof of malpractice coverage to be available by (date) _____
Bylaws to be complete by (date) _____

Future minutes to approve:

	Responsibility of
Stock redemption agreement	
Employment contracts	
Disability insurance	
Sick-pay plan	
Group life insurance plan	
Health, accident, and major medical	
Pension or profit-sharing plan	
Contribution to pension or profit-sharing plan	
All bonuses	

Decisions and Action Before Incorporation

	Responsibility of
Order stationery, billing forms, etc., in corporation name.	
Change telephone listing.	
Change names of utility accounts and deposits.	
Change malpractice insurance coverage.	
Corporation to be insured? _____	
How much? _____	

Individuals to be insured? _____

How much? _____

(State law minimum requirements are _____)

Obtain general insurance to cover corporation.

Is insurance adequate? _____

Announcements: Permitted? _____

Wanted? _____

Arrange for necessary bank accounts.

Account titles	Bank at	No. of checks needed	1st check number	Authorized signature

What will happen to old bank accounts? _____

Responsibility of

Apply for I.D. numbers.

Total number of employees, including professionals _____

Federal I. D. Form SS-4 to
be prepared by _____
State number, if any, to
be prepared by _____ _____
State U.C. forms.
Can experience rate be transferred? _____ _____
State sales tax forms.
Needed in this state? _____ _____
Subchapter S election.
Desired? _____
When begin? _____ End? _____
Client notified of rules affecting election
on a change in stock ownership? _____
How? _____
Permitted for state income tax? _____ _____
Transfer of assets to the new corporation
Responsibility for accounting _____
Responsibility for legal _____
Agreed treatment of payables (don't transfer) _____
Agreed treatment of receivables _____
Retained? _____ Assigned? _____
Advised of Section 482 problems if assigned? _____ How? _____

If ledger cards are reproduced for billing, how will corporate name be shown? _____

Will new ledger cards be prepared? _____

Is it necessary to red-line or otherwise indicate cut-off point on ledger card? _____

Should a detailed schedule of receivables be prepared at cut-off date? _____

Who will collect? _____

In whose account will collections be deposited? _____

Amount of cash to be transferred (borrow more if needed) _____

Agreed treatment of

work-in-process _____

goodwill _____

any partnership life insurance _____

real estate _____

fixed assets _____

deposits, etc. _____

notes and mortgages payable _____

Are any deeds, leases, bills of sale, minutes, etc., needed to effect transfer? _____

Describe _____

If yes, will be prepared by _____

Are present partnership capital accounts in ratio to stock of each? _____

If not, how will they be equalized:

By notes from some partners to others? _____

By adjusting partnership taxable earnings? _____

By ignoring; leaving each with a different taxable basis in his stock? _____

By future partnership draws? _____

By other means (describe) _____

Will transfer be subject to Section 351? _____

(See attached form. This form may be duplicated and used for drafts to be attached to the respective tax returns of the transferor and the resulting controlled corporation by striking out unnecessary or inapplicable wording, or it may be used as a basis for drafting suitable statements.)

Opening new books. Responsibility of _____

New general ledger accounts and journal columns explained to bookkeeper by _____

Notification of incorporation:

Employees	will be notified by	_____	When? _____	How?	_____
Vendors	will be notified by	_____	When? _____	How?	_____
Lessors	will be notified by	_____	When? _____	How?	_____
Prof. Society	will be notified by	_____	When? _____	How?	_____
Prof. Publication	will be notified by	_____	When? _____	How?	_____

Termination of Keogh plan. Responsibilty of _____

Does a plan exist? _____ If so, who is trustee? _____

Is it an insured plan? _____

Can it be left intact, but inactive? _____
Decision as to disposition _____
Target date to begin business as a corporation
What is anticipated fiscal year? _____
Does law permit Sub S election and a fiscal year? _____
Is partnership now on a fiscal year? _____ What date? _____
Other considerations:
Economies of a Jan. 1 date _____
Other _____
Tentative target date _____ Alternative _____
Payroll forms
Does bookkeeper understand that professional men will be employees, as are all others? _____
W-4 forms must be prepared for professional men.
Must implement new depositary receipt system.
Bookkeeper must understand depositary requirements prior to receiving new forms.
Instruction and follow-up will be responsibility of _____
Effect of withholding on estimates
Professional men's withholding computed by _____
Amended estimates responsibility of _____

Final Returns	Responsibility of
Sch. C-1040 (if individual)	
1065 (if partnership)	
1120 (if a corporation)	
941	
940	
State U.C. return	
Fed. U.C. return	
W-2's, etc.	
State income tax return	
State sales tax return	
1099's	

Special

For doctors: Consider narcotics license problem _____

Action needed: _____

Election to amortize organizational expenses

Under Section 248, fees must be paid before end of the first corporate year end.

Election responsibility of _____

Change occupational licenses if required.

Change responsibility of _____

If This Is a Merger of Practices

Names of Prior Entities	Type (Corp., Partnership, Individual)

New bookkeeper will be _____

Bookkeeping address _____ Zip _____

Additional office address _____ Zip _____

Additional office address _____ Zip _____

Will additional offices continue? _____ How long? _____

State purpose and intentions for additional offices. Will they maintain identity? Will they maintain accounts receivable records? Will they collect fees? Will they disburse funds? Payroll? Describe and comment. List problems, if any, including need for regular or imprest bank accounts. _____

Bookkeeper's name _____ Phone _____
Located at _____
Bookkeeping method employed:
Manual _____ Accounting machine (make) _____
Pegboard _____ Computer service bureau (name) _____
Outside public bookkeeper (name) _____
Firm write up (duties) _____
Nature of accountant's continuing engagement:

Opinion _____	Annual _____	1120 _____
Non-opinion _____	Semi-A _____	1120S _____
Write up _____	Quarterly _____	St. Return _____
*Actuarial _____	Monthly _____	City Return _____

Other forms (indicate responsible person):

940 _____	Fed. U.C. Ret. _____	2950 _____	Pers. Prop. _____
941 _____	St. U.C. Ret. _____	990P _____	Intang. Tax _____
W-2's _____	Sales Tax _____	1099's _____	Franchise Tax _____

* Or schedule of profit-sharing trust fund allocations.

Summary

This Schedule A prepared by_____ Date _____

Reviewed by_____ Date _____

Items not yet completed _____

_____

_____

_____

Problem areas requiring attention _____

_____

_____

_____

Copies of correspondence attached

STATEMENT FILED BY TAXPAYER TRANSFERRING PROPERTY
IN EXCHANGE FOR STOCK PURSUANT TO
REG. 1–351–3[a] I.R.C. of 1954

1. Description of Property Transferred to

_____

_____

I.D. No. _____ _____
[Date]

	Fair Market Value [Do not type]	Cost or Other Basis of Transferor
Cash		
Accounts Receivable		
Supplies Inventory		
Fixed Assets:		
_____		
_____		
_____		
_____		
_____		
Other Assets:		
_____		
_____		
_____		
_____		
Total Assets Transferred		

2. Information regarding stock of controlled corporation received:
   i. [Common] [Capital] stock—Par value $_____
   ii. Received _____ shares
   iii. Fair market value of stock received in exchange: $_____ per share.
3. [Description of any] [No] other securities received in connection with the exchange. [See Reg. 1.351[a] if applies].
4. [Amount of] [No] money received in connection with the transaction.
5. [Description of] [No] property received other than that described above passed to the transferor in the exchange. [See Reg. 1.351[a] if applies].
6. Liabilities assumed by controlled corporation:
   i. Description:

		Amount
[Accounts Payable]	[NONE]	[NONE]
[Liabilities in connection with assets transferred:]		
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

   ii. Reason for assumption by controlled corporation: _____
   iii. Does assumption eliminate transferor's primary liability? _____

SCHEDULE B

Fringe Benefit Plans
(Early stage information and decisions)

Group Health, Accident, and Major Medical Insurance

(Must in general cover all employees)
Interested in corporation adopting a plan? _____ Insured? _____
Responsibility of _____ to investigate and report back to group.
Will talk with only _____, insurance agent, or _____ several agents.
To report back by _____
Responsibility of _____ to see that minutes properly authorize plan as employee benefit.

Responsibility of _____ to see that plan will qualify tax-wise.
Investigate plan that will:
Provide the corporation will pay all premiums? _____
Employees to pay a portion? _____
Present company now has coverage written by _____

Disability Insurance

Interested in corporation adopting a plan? _____
Coverage desired (range) for each professional man and for nonprofessional employees:

Name	Coverage Range: From	To
_____	$ _____	$ _____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

Nonprofessional employees
Waiting period _____ Cancellable? _____
Coverage for sickness _____ accident _____
Sick-pay plan? _____ Responsibility of _____
(Must cover nonprofessionals to qualify a sick-pay plan)

Responsibility of _____ to investigate and report back to group.
Will talk with only _____, insurance agent, or _____
several agents.
To report back by _____
Responsibility of _____ to see that minutes properly authorize plan as an employee benefit.
Responsibility of _____ to see that the plan will qualify tax-wise.
Present partners have coverage written by _____
_____
_____

Note: This is urgent. Coverage should begin at once. Disability benefits in employment contract assume this coverage exists.

Group Life Insurance

(Internal Revenue Service requires brackets for all employees in a small plan, no one bracket to be greater than the previous bracket by more than 2½ times, and the highest no more than 10 times the lowest.)

Interested in corporation adopting a plan? _____
Responsibility of _____ to investigate and report back to group.
Will talk with only _____, insurance agent, or _____
several agents.
To report back by _____

Responsibility of _____ to see that minutes properly authorize plan as an employee benefit.
Responsibility of _____ to see that plan will qualify tax-wise.
Number of employees who can be covered _____
If the employees number less than 10, can the increased restrictions be overcome? _____
Want more than $50,000 for professional men? _____
(excess taxable, but small)
Does state law permit irrevocable assignment? _____
If so, will policies be assigned to avoid estate tax? _____
Note: Again, this is most urgent. Coverage should begin at once.

Summary

This Schedule B prepared by _____ Date _____
reviewed by _____ Date _____
Items not yet completed _____
_____
_____
_____
Problem areas requiring attention _____
_____
_____
_____
Copies of correspondence attached.

SCHEDULE C

Pension and Profit-Sharing Plans (Early stage information and design)

Earnings Schedule—Nonprofessionals and Professionals

Prepare schedule of nonprofessionals,
listing name, position, full or less than 20 hours per week employment, age, date employed, expected annual salary this current year. Attach schedule to this form.
(This will indicate turnover and forfeiture possibilities, the effect of age and waiting period restrictions, and potential cost of any plan for nonprofessionals.)

Preparation responsibility of _____

Prepare schedule of professionals,
listing name, position, age, date began work, prior year income, and expected current year income.

Preparation responsibility of _____

Explain Differences in Types of Employee Plans

Characteristics of each type explained to professional men:
Explained by _____ How? _____
Characteristics of a fixed benefit pension plan _____
Characteristics of a money-purchase pension plan _____
Characteristics of a profit-sharing plan _____

Explain Integration with Social Security

(Particularly attractive if there is a large ratio of nonprofessional employees to professional)
Explained by _____ How? _____

General Questions for Choice and Design of a Plan, or Plans

1. Do you favor maximum contributions immediately? _____
2. Do you favor integration with S.S. to extent possible? _____
3. Is there a wide age difference in professional men? _____
4. Should the plan favor the older men? _____
5. If there are two plans, should one plan favor older men? _____
6. Roughly how much spendable income can be spared for investment? _____
7. How many want more insurance even above new group life coverage? _____
   _____
8. How many would consider taking paid up life on some personal insurance if difference could be provided in an employee plan? _____
   _____
9. Is there an insurability problem because of health or age? _____
   _____
10. What are personal preferences:
    a. A set retirement income _____
       (requiring more conservative investment policy), or
    b. The results of a growth investment policy _____
       (Profit-sharing plans pass on growth and forfeitures to the employee)

a. Forfeitures to reduce future corporate payments _____ or

b. Forfeitures credited to employees _____

If a set retirement income is preferred, what percent of current income would be a satisfactory retirement income? _____

a. Insurance _____ or

b. Security investments _____

If security investments, what kind? _____

Who will furnish investment advice? _____

11. Who will serve as pension trust committee? _____
12. Who will be trustee of plans? _____
13. Who is responsible to design plans? _____
14. Who will review plans? _____
15. If a pension plan is used, who will make actuarial calculations? _____
16. Who will review estate planning? _____

(Section 2039(c) excludes benefits if payable to a designated beneficiary other than the estate or legal representative of the decedent. It is good planning to provide that the amounts payable under a qualified plan shall not be paid to the spouse but, rather, shall be paid to a trust for the lifetime benefit of the spouse. In this way the proceeds will also pass free of the estate tax on the spouse's estate.)

17. Who is responsible to write the booklet describing the plan for the employees?

_____

18. Who is responsible to open a bank account for the pension or profit-sharing trust?

19. Who is responsible to request a federal I.D. number (on Form SS-4) for the trust?

20. Who is responsible to qualify the plan with the Internal Revenue Service? (See Rev. Proc. 67-4, Treas. Regs. 1.404(A)-2(a), and Form 4573).

Timing Problems

A profit-sharing plan immediately presents a problem:

a. Because of the risk of reallocation of beginning receivables under Section 482, these receivables might not be transferred to the corporation. The cash-basis professional corporation may then operate at a loss in the initial period. This could restrict contributions to a profit-sharing plan.

b. Section 1379 added by Section 531 of the Tax Reform Act of 1969 renders a profit-sharing plan in a Subchapter S corporation unqualified if forfeitures accrue to stockholder-employees owning over 5% of the stock. Yet it may be valuable to initially elect Subchapter S to pass through the beginning operating losses or protect against a 482 reallocation if receivables are transferred.

Thus, the adoption of any plan should be delayed, or the first plan should be either a

fixed benefit or money-purchase plan. THERE IS RARELY A NEED FOR HASTE—CORPORATE PLANNING SHOULD COME FIRST!

Write a general description of the timetable for implementing the desired plan or plans and the hopes for contributions in the first fiscal year.

_____

_____

_____

_____

Anniversary Date of Plans

Proposed anniversary date _____
(This should be the expected fiscal year of the corporation.)

Amounts Professional Men Feel They Can Set Aside

1. No more than 6% of income _____
2. From 6% to 10% of income _____
3. At least 10% but not more than 25% _____
4. Over 25% every year _____

Key Features of the Plan

A. Deferred vesting understood? _____
How long a deferred vesting desired by the professional men:
In a fixed benefit pension plan _____
In a money-purchase pension plan _____
In a profit-sharing plan _____

B. Should employees be able to contribute voluntarily? _____
(only disadvantage could be that administration of plan is more difficult)

C. Should the plan permit employees to borrow from the plan?
In a fixed benefit pension plan? _____
In a money-purchase pension plan? _____
In a profit-sharing plan? _____
(This is ordinarily provided only in profit-sharing plans.)

D. What waiting period for new employees is desired? _____
(can be discriminatory if long; also will discourage new professional men the firm may wish to attract; less advisable for profit-sharing plan)
What minimum age for eligibility will be set? _____
(can be discriminatory if minimum age is set too high; less advisable for profit-sharing plan)

E. How will compensation be defined for purposes of the plan—base pay only, or including bonuses and overtime? _____
(If it includes bonuses, increasing earnings will materially affect contributions *required* under a pension plan formula. It will affect such contributions drastically for older men under a fixed benefit pension plan.)

F. How often should the assets of the plan be valued? _____

G. Will the allocation of the earnings of the plan be affected by any partial withdrawal by an employee during the year? _____

H. Should the percentage of compensation to be contributed to a profit-sharing plan be written into the plan or left flexible? _____

I. If practical, does the feature of earmarking in a money purchase pension plan or profit-sharing plan have appeal? _____
(Administration will be made more difficult.)

J. Will the plan be contingent on approval by the Internal Revenue Service? _____
(Wording should refer to the *initial* approval and should not provide for automatic but elective termination in the event the Internal Revenue Service rules adversely.)

Summary

This Schedule C prepared by _____ Date _____
reviewed by _____ Date _____

Items not yet completed _____

_____

_____

_____

Problem areas requiring attention _____

_____

_____

_____

Copies of correspondence attached

SCHEDULE D

Post-Incorporation Follow-up

Follow-up of Schedule A: Pre-Incorporation Planning

Agreement to incorporate
Used by attorney? _____
Copy requested (date) _____ Received (date) _____ Examined by _____
Any comments? _____

Bylaws
Copy requested (date) _____ Received (date) _____ Examined by _____
Any comments? _____

Charter
Copy requested (date) _____ Received (date) _____ Examined by _____
Date charter granted _____ Date business began _____
Corporate name approved _____
Number of shares authorized _____ Par _____

Stock issued

Information re stockholders, number of shares, etc., on Schedule A correct? _____

Differences: _____

Minutes (original minutes)

Copy requested (date) _____ Received (date) _____ Examined by _____

Directors & officers on Schedule A correct? _____

Section 1244 stock issued? _____

Authorize acquisition of assets _____

Approve assumption of mortgages _____

Approve employment contracts _____

Errors, differences with Schedule A _____

Fictitious name

Status _____

Any changes in professional advisers, suppliers, insurance men? _____

Differences: _____

Stock redemption agreement

Effective date _____

Copy requested (date) _____ Received (date) _____ Examined by _____

Stock certificates inscribed to indicate existence? _____

Any comments? _____

Memo of understanding

Copy requested (date) _____ Received (date) _____ Examined by _____

Any comments? _____

Employment contracts
Effective date _____
Copy requested (date) _____ Received (date) _____ Examined by _____
Bookkeeper paying correct amount? _____
Terms agree with information on Schedule A? _____
Any comments? _____
Flagged for renewal? _____ Responsibility _____

Minutes approving stock redemption agreement & employment contracts
Copy requested (date) _____ Received (date) _____ Examined by _____
Require repayment of disallowed payments? _____
Any comments? _____

Stationery, billing forms, etc.
Copies requested (date) _____ Received (date) _____ Examined by _____
Any comments? _____

Telephone, other utilities
Accounts & listings changed? _____ How advised? _____

Malpractice insurance
Corporation insured? _____ Men? _____ How advised? _____
Coverage amounts _____ Comment: _____

General casualty insurance
Corporation insured? _____ How advised? _____
Any comments? _____

Bank accounts

Used corporation accounts from start? _____

Any comments? _____

Status of old bank accounts _____

I. D. numbers

Federal form filed by _____ I.D. no. assigned _____

State form filed by _____ I.D. no. assigned _____

Unemployment compensation forms

Application form filed by _____ Date _____

Experience rate transfer requested by _____ Date _____

Results _____ as of (date) _____

State sales tax forms

Needed? _____ Forms filed by _____ Date _____

Subchapter S election

Desired? _____ Filed by _____ IRS acknowledged (date) _____

Will it be continued? _____

Any comments? _____

Transfer of assets

Opening balance sheet requested? _____

Date requested _____ Received _____ Examined by _____

Treatment of opening payables _____

Treatment of opening receivables _____

Treatment of opening work-in-process _____

Transfer made as indicated in Schedule A? _____
Any problems? _____
Any comments? _____
Section 351 worksheet attached? _____
Leases, deeds, etc. transferred _____

New books opened? _____

Vendors notified? _____

Professional societies notified? _____

Professional publications notified? _____

Keogh plan:
How concluded: _____

New payroll records opened? _____
W-4's filed? _____ New depository receipt system working? _____
Professionals' withholding calculated? _____
Professionals' estimates amended? _____

Final tax returns of old practice
All forms listed on Schedule A filed _____
Exceptions/comments _____

Special
Narcotics licenses (for doctors) complete _____
Amortize organizational expenses elected _____
Occupational licenses proper _____
Any state franchise tax forms filed _____

Follow-up of Schedule B: Fringe Benefit Plans

Group health, accident, & major medical insurance
Coverage info. req.(date) _____ Received (date) _____ Examined by _____
Date in force _____ Comments? _____

Disability insurance
Coverage info. req.(date) _____ Received (date) _____ Examined by _____
Date in force _____ Comments? _____

Group life insurance
Coverage info. req.(date) _____ Received (date) _____ Examined by _____
Date in force _____ Comments? _____
Group life irrevocably assigned for estate tax purposes? _____

Minutes approving fringe benefit insurance plans
Copy requested (date) _____ Received (date) _____ Examined by _____
Errors, differences with Schedule A or reported coverage _____
_____
Sick-pay plan approved? _____

No. Employees Covered _____
(If more than 25, plan is subject to Welfare and Pension Plan Disclosure Act. Form D-1 is due in 90 days after establishment of plan or after the 26th participant is included.)

Form D-1 Required? _____ Filed? _____ By _____ Date _____

Follow-up of Schedule C: Pension and Profit-Sharing Plans

Decision was to adopt:

Type of Plan	% of Compensation Contributed	Retirement Benefits	Integrated with S.S.?	Insurance in Plan?	Trustee
Fixed benefit pension					
Money-purchase pension					
Profit-sharing					

Copy requested (date) _____ Received (date) _____ Examined by _____
Copy requested (date) _____ Received (date) _____ Examined by _____
Any comments? _____
Estate planning desired? _____ Responsibility of _____
Status of estate planning _____
_____

Plan*_____*Follow-up

Booklet describing plan for employees
Copy requested (date) _____ Received (date) _____ Examined by _____
Any comments? _____
Distributed to employees? _____ By _____ Date _____

Request to the Internal Revenue Service to Determine Status (Form 4573)
Request filed? _____ By _____ Date _____
IRS reply received? _____ Date _____ Approved/Exceptions _____

Efforts made to cure exceptions _____

_____

Status at this date _____

Form 2950 filed? _____ By _____ Form 990P filed? _____ By _____

Bank account opened in name of trustee? _____

Federal I.D. number applied for? _____ Issued? _____ Number is _____

No. Employees Covered _____

(If more than 25, plan is subject to Welfare and Pension Plan Disclosure Act. Form D-1 is due in 90 days after establishment of plan or after the 26th participant is included.)

Form D-1 Required? _____ Filed? _____ By _____ Date _____

Plan _____ *Follow-up: (Use if there is a second plan)*

Booklet describing plan for employees

Copy requested (date) _____ Received (date) _____ Examined by _____

Any comments? _____

Distributed to employees? _____ By _____ Date _____

Request to the Internal Revenue Service to determine status (Form 4573)

Request filed? _____ By _____ Date _____

IRS reply received? _____ Dated _____ Approved/Exceptions

Efforts made to cure exceptions _____

_____

Status at this date _____
Form 2950 filed? ____ By _____ ; Form 990P filed? ____ By _____

Bank account opened in name of trustee? _____

Federal I.D. number applied for? _____ Issued? _____ Number is _____

No. Employees Covered _____
(If more than 25, plan is subject to Welfare and Pension Plan Disclosure Act. Form D-1 is due in 90 days after establishment of plan or after the 26th participant is included.)

Form D-1 Required? _____ Filed? _____ By _____ Date _____

Summary

This Schedule D prepared by _____ Date _____
reviewed by _____ Date _____

Items not yet completed _____
_____
_____
_____

Problem areas requiring attention _____
_____
_____

Copies of correspondence attached

SCHEDULE E

Annual Review

(*Note:* If more than one employee benefit plan exists, use a separate Schedule E for each)

Employee Benefit Plan: Type of Plan _____

Review Plan

Were there any modifications or amendments to the plan? _____

If yes, describe _____

_____

If yes, do minutes reflect board of directors' action? _____

Did the board adopt change *subject* to IRS approval? _____

Request for determination filed with IRS respective to change? _____

Any change in laws or IRS position that affects plan this year? _____

Contributions

How much contributed in year? _____

Was contribution within maximum permitted by IRS? _____

If not, how was board of directors informed? _____

Was contribution to a no-formula profit-sharing plan timely approved by the board? _____

If not, how was board of directors informed? _____

Was contribution timely made (for a cash-basis taxpayer)? _____

If not, how was board of directors informed? _____

What will be done to cure differences? _____

Employees

Was the schedule of each employee's equity in the plan completed? _____

If not, what will be done to follow up? _____

Was information of his equity transmitted to each employee? _____

Were new employees informed of terms of plan? _____

Investments in Plan

Pension plan—actuarial calculations submitted? _____

Profit-sharing plan—assets valued and change distributed among participants? _____

Forfeitures reallocated? _____

Tax Returns

Year end of plan _____

Form 990P filed? _____ By whom? _____ When? _____

Form 2950 filed? _____ By whom? _____ When? _____

Welfare and Pension Plan Disclosure Act

Annual Report due 150 days after plan year ends. (Form D-2 is required if there are 100 or more participants at any time during year.)

Required? _____ Filed? _____ By _____ Date _____

(Form D-3 is required if there are between 26–100 participants at any time during year.)

Required? _____ Filed? _____ By _____ Date _____

New Employees in Year

Notified of terms of employee benefit plan? _____

Assign group life insurance for estate tax? _____

Estate planning regarding share of employee plan? _____

Stock Redemptions in Year

In accordance with contract? _____

Certificates secure? _____

Approved by minutes? _____

Stock Sales by Stockholders in Year

Collapsible corporation problem considered? _____
Investment tax credit recapture if Subchapter S? _____

Compensation

Employment contracts updated? _____
Approved in minutes? _____
Bonuses approved? _____
Dividends voted? _____

Corporate

Stockholders' meetings? Dates _____
Any action of interest in minutes? _____
_____
Anything obviously missing? _____
_____
Board meetings? Dates _____

Changes in officers, compensation, other action _____

_____

Anything obviously missing from minutes? _____

_____

Subchapter S Election

Corporation (is/is not) now a Subchapter S corporation.

A review of client's conditions and any new federal statutes affecting Subchapter S corporations, indicates the client (should/should not) elect Subchapter S. Client's decision is _____

State what action taken or recommended—with appropriate timing—to accomplish decision. _____

New stockholders in year (did/did not) make timely elections under Subchapter S _____. Client knows of this requirement? _____How informed? _____

Corporation notified to distribute the prior year undistributed income within 2½ months from end of the fiscal year? _____How notified? _____

Note: The changes in the Tax Reform Act of 1969 may seriously affect many Subchapter S professional corporations. A review may indicate the need to abandon the Subchapter S election.

Summary

This Schedule E prepared by _____ Date _____

reviewed by _____ Date _____

Items not yet completed _____

_____

_____

Problem areas requiring attention _____

_____

Copies of correspondence attached

DATE DUE

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OC 4 '88
JA 16 '90

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